Derivatives Regulation - Johnson, Hazen, Ervin, Mills, and Trkla, § 1.02, DEFINITIONS AND DESCRIPTIONS OF TERMS

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1 Philip McBride Johnson, Thomas Lee Hazen, Susan C. Ervin, Charles R. Mills & Kathryn M. Trkla, Derivatives Regulation § 1.02 (1st Edition, 2021 Cum. Supp. 2004)
1st Edition, 2021 Cum. Supp.

Last Updated: 10/2020

[1] The Essential Commodity

Since federal regulation of derivatives pivots on whether a commodity is involved, [1] it is necessary first to define that term. The Act provides a definition that clearly identifies certain types of assets but contains ambiguities as well. Section 1a of the Commodity Exchange Act lists as commodities a number of agricultural products that, over the years, have been traded on the nation's organized exchanges, including:

> wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solarium tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice.... [2]

These itemized commodities are agricultural in nature, and each was incorporated in the Act when and as it became the subject of trading, or expected trading, on a commodities market. Repeated amendments to the Act were made necessary in order to keep the list current. Not every enterprise involving a listed commodity will itself be classified as a commodity under the Act. For example, a joint venture to purchase a commodity is not itself a commodity so as to be subject to regulation under the Commodity Exchange Act. [3] On the other hand, the CFTC has taken the view that agricultural products, such as lumber, which is not specifically enumerated on the list in section 1a(4) of the Act, are nevertheless subject to the Act's restrictions governing agricultural commodities within the meaning of the Act. [4]

By 1974, futures trading had branched far beyond the agricultural sphere. Certain active contracts, like those in iced broilers (processed chickens packed in ice) and plywood, came close to being of the same genre as the listed items but had not yet been added to the definition. Other contracts, however, had no kinship at all with the itemized products. There were contracts in gold, silver, foreign currencies, and propane, for example. The Chicago Board of Trade was readying the first contract in a security-modified pass-through certificates of the Government National Mortgage Association (GNMAs). The world of commodities trading was changing drastically, and quickly.

In addition, contracts had been traded for many years on certain exchanges in products produced abroad, such as coffee, cocoa, and sugar. In years past, Congress had chosen to exclude these foreign products from its definition of *commodity.* The rationale for regulating trading in foreign-origin products may have seemed unpersuasive to Congress. For example, it could prove impractical to attempt to control such trading where foreign producers were involved, and because American products were not the subject of trading, there may have seemed to be less need to regulate for the sake of protecting domestic commerce.

In 1974, with the enactment of the Commodity Futures Trading Commission Act (massively amending the Commodity Exchange Act), the mood of the Congress had changed. Section 2(a)(1) was revised to include contracts in foreign-origin products as well as any other subject of futures trading. This result was achieved by adding a phrase at the end of the itemized list: "and all other goods and articles, except onions…, and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in…." [5] By this means, Congress expanded the definition of *commodity* to encompass virtually anything that is or becomes the subject of futures trading, intangible as well as tangible. Onions are excepted because futures trading in them had already been banned. [6] Congress looked so foolish in the 1950s when it prohibited onion futures that the intervening half century of calm aroused hope that it has absorbed that lesson. Congress has now condemned to the same fate any futures contracts linked to movie box office receipts. Section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 amends the definition of a "commodity" to exclude these receipts so that box office receipts join onions as a banned trading instrument. [6.1] This development was spearheaded by the Motion Picture Association of America (MPAA) that hinted broadly of adverse consequences to its industry from the trading of such instruments.

On occasion, the CFTC has refused to permit trading in certain futures contracts. For example, in April, 2012, the Commission explained: "as a result of reviewing the complete record, the CFTC determined that political event contracts involve gaming and are contrary to the public interest, and cannot be listed or made available for clearing or trading." [6.2]

A fair reading of the amended and expanded definition suggests that, as for "all goods and articles…and all services, rights and interests," their status as statutory commodities does not emerge until they become the subject of futures trading. Although this method of converting something into a commodity may seem curious, it illustrates an important principle of commodities regulation: its interest is in a form of economic activity, rather than in the attributes or character of the underlying subject. The economic activity in question is futures and commodity options trading; the nature of the commodity does not affect the regulatory result.

Because an item or interest does not become a commodity until futures trading in it is initiated, it is unlikely that jurisdiction under the Act arises for cash or spot transactions in these newer subjects unless and until they become traded for future delivery. [7] This result is consistent with the concept that the CFTC's interest in normal commercial transactions is related primarily to their interaction with a parallel market in futures contracts or similar instruments.

While it seems logical that an item should not become a "commodity" until it is the subject of futures trading under the phraseology of the Act, that analysis raises issues of its own. In the case of an *option* on a particular good, service, right, or interest for which there is no futures contract, the CFTC is unlikely to concur that it lacks jurisdiction over that option simply because the underlying interest is not yet traded for future delivery. Indeed, despite a direct request for guidance, the CFTC has declined to clarify even in the case of *futures contracts* whether the phrase "presently or in the future dealt in" impacts status as a statutory commodity (i) if a futures contract is listed for trading on a U.S. market, whether or not being traded; (ii) only if that futures contract is actively traded; or (iii) if a futures contract is listed for trading on a *foreign* market. Nor has the CFTC been willing to address status as a "commodity" where particular transactions were made *before* futures trading was initiated or *after* futures trading has been discontinued. [8]

In addition to onions and box office receipts, the Act (and therefore the commodity definition) does not apply to "transactions in security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments" if the transactions are not swaps, are effected between qualified parties, and are not traded for future delivery on an organized exchange. Financial *institutions* [9] commonly trade among themselves in these instruments, and in some instances, "forward commitments" occur having certain of the attributes of a futures contract. Nevertheless, unless those dealings occur on an organized commodities market, where the investing public as well as sophisticated financial institutions can participate, or the transactions are marketed to certain retail customers lacking specific qual-ifications, the Act is not applicable. [10] The Department of the Treasury first urged an exclusion in 1974 on the ground that the protections of the Act were not needed by sophisticated participants in these private transactions. [11] The Treasury Amendment exclusion was given a broad reading by a federal district court and by the Fourth Circuit in *Salomon Forex, Inc. v. Tauber.* [12] However, the Second Circuit gave a contrary ruling in *CFTC v. Dunn*, wherein it was held that the phrase "foreign currency transactions" did not include options on foreign currencies. [13] The Second Circuit thus held that off-exchange options on foreign currencies were within the Commission's subject matter jurisdiction. However, the Second Circuit was reversed by the Supreme Court. [14] The Court reasoned that both the clear language of the statute and the legislative history supported the conclusion that Congress intended a broad exclusion for over-the-counter foreign currency transactions by the public as well as by institutions, including options transactions. [15]

Amendments to this provisions in year 2000 made clear that the CFTC has regulatory jurisdiction over these types of transactions when they involve futures contracts or options and are marketed to persons that are not "eligible contract participants" as defined in section 1a(12) of the Act. In this way, Congress assured that the promotion of these products to a retail or general public audience would enjoy federal oversight and protections. [16]

As noted at the outset of this chapter, there has been continual expansion of the futures and derivatives markets. Financial futures—on government securities, private debt issues, foreign currencies, and stock indexes—have become an increasingly important part of the commodities world. The result has been to offer investors a wider choice of investment alternatives. Another byproduct has been increased regulatory needs. For example, broad-based stock index futures and options thereon, which are subject to exclusive regulation by the CFTC, may be in competition with options directly on stock indexes that are regulated by the Securities and Exchange Commission (SEC). [17] In addition to the growth of financial futures, there has been a dramatic increase in the public trading of options on futures. [18] In 1981, the CFTC implemented a pilot program for exchange-traded options on futures. [19] In 1982, Congress lifted the ban on agricultural options. [20] In 1986, Congress authorized the CFTC to make permanent its pilot options programs. [21] The Commodity Futures Modernization Act of 2000 [22] expanded the field even further by permitting security based futures products that formerly were prohibited under the Act.

[2] Derivative Investments and Jurisdiction

The meaning of *commodity* under the Act should not be confused with a separate, recurring issue: whether the CFTC's regulatory jurisdiction is exclusive. The latter question arises because the breadth of the word *commodity* can clearly subsume subjects that Congress has assigned, by other statutes, to the regulatory domain of another federal agency. For example, Congress has vested the SEC with regulatory jurisdiction over securities as defined in the Securities Act of 1933 and the Securities Exchange Act of 1934, which includes, *inter alia*, investment contracts. [23]

[A] Commodities and Securities—Basic Definitions

Most commodities, and hence futures contracts, do not fall within the definition of *security.* [24] Where, however, the promoter of the investment offers management services and the success of the investment is due to the promoter's efforts rather than market fluctuations, a security may be found to exist. [25] The weight of authority holds that an individual managed commodities account is not a security. [26] In contrast to the typical raw material or bullion contract, if the underlying commodity is itself a security, such as with government bonds, the securities laws, on their face, would seem to apply. [27] However, a security within the meaning of those statutes can also be a commodity under section 1a of the Commodity Exchange Act once it becomes the subject of "contracts for future delivery."

Until 2000, under former section 2(a)(1)(A)(i) of the Commodity Exchange Act, the CFTC's regulatory jurisdiction was exclusive and preemptive if those contracts were "traded or executed on a contract market designated pursuant to section 5 of this Act or any other board of trade, exchange or market." [28] The question of regulatory assignment, therefore, turned on whether a commodity was involved and was the subject of futures trading on an organized exchange or in the over-the-counter markets permitted under the Commodity Exchange Act. [29] It mattered not that the commodity was also a security. Even so, the SEC was foreclosed from invoking its statutory powers if the security was traded for future delivery on an organized market. Efforts to secure a regulatory role for the SEC by showing that a commodities exchange was sponsoring a futures contract in a security, therefore, were unproductive under the wording of former section 2(a)(1). The 1982 amendments to the Commodity Exchange Act, although not giving the SEC a regulatory role, provided that the SEC must be given an opportunity to participate in CFTC decisions whether to permit contract market trading of a futures contract for a group or index of securities. [30] The basic division of authority between the two agencies was dramatically altered in 2000. The Commodity Futures Modernization Act of 2000 [31] expanded the cooperation of the SEC and CFTC as security futures products on narrow-based security indexes and on individual equity securities may now be traded under the Commodity Exchange Act. [31.1]

Prior to the Commodity Futures Modernization Act of 2000, the SEC's role in approval of futures on securities indexes was subject to judicial review. Thus, the SEC's refusal to permit listing of futures on the Dow Jones Utilities and Transportation averages was overturned by the Seventh Circuit. [32] The SEC took the position that these indexes were too narrow and thus did not comply with the then statutory requirement that they be sufficiently broad-based to reflect a substantial segment of the market. [33] The Seventh Circuit concluded that the averages adequately represented substantial segments of the market and were not subject to manipulation. The case seems to make three important points about the jurisdictional accord: (1) that an index futures contract that correlates well in price behavior with the intended industry segment meets the "reflects" test even if it is comprised of only a small fraction of the total sector's issuers; (2) the statutory phrase, "readily susceptible" to manipulation, means a "high probability" of being manipulated, and (3) the SEC has only the narrow statutory time window for deciding issues under the jurisdictional accord. The Seventh Circuit's decision reflects precisely what was intended by the jurisdictional accord.

Amendments to the Act in year 2000 shifted this test from an economic analysis with emphasis on weaknesses in structure of the indices that might heighten the risk of price manipulation to a mechanical test based principally on the number of separate stocks in the index, the weightings allotted to major stocks, daily trading statistics, and other mathematical calculations, eliminating any need to determine whether the index is in fact flawed. Those indices that fail the numerical test are referred to as "narrow-based" security indexes. [34] These futures contracts, as well as futures contracts on individual securities, are co-regulated by the CFTC and the SEC and are subject to standards and requirements found in both the federal securities and commodity laws. Indexes that pass the standards, however, are regulated by the CFTC, and the SEC no longer must concur in their approval.

In 1988, three securities exchanges [35] filed applications to permit exchange trading of stock index participation instruments (also known as stock baskets). These instruments had many characteristics of futures contracts. If characterized as futures contracts, these index participation units fell under the CFTC's exclusive jurisdiction. Because of their similarity to futures contracts, the CFTC took the position that they should be regulated as such. [36] In March 1989, the SEC granted the securities exchanges' applications and approved trading of these three stock baskets on securities exchanges. [37] The SEC's position that these index participation units were securities started anew the SEC/CFTC jurisdictional struggle. [38] The Chicago Mercantile Exchange (CME) challenged the SEC action, claiming that the new instruments were futures contracts and as such are subject to the exclusive jurisdiction of the CFTC. [39] The Seventh Circuit refused to stay trading of the new instruments in the securities markets pending judicial review, [40] but eventually ruled that these index participation units were futures contracts and as such were subject to CFTC not SEC jurisdiction. [41]

In the course of its opinion upholding the CFTC's exclusive jurisdiction over index participation units, the Seventh Circuit referred to the 1982 jurisdictional accord. Under the terms of the 1982 CFTC-SEC accord, instruments that could be classified as both securities and futures contracts were placed under the jurisdiction of the CFTC. [42] As explained by the Seventh Circuit, the premise underlying the jurisdictional accord was that if an instrument can be classified as both a security and a futures contract, exclusive jurisdiction lies with the CFTC. [43]

The commodities exchanges did not fare as well in their challenge to SEC registration of a clearing agent for an electronic trading system for options on government securities. [44] Commodities exchanges had complained that the registration as a clearing agent was improper since this, in essence, involved the SEC's recognition of an unregistered securities exchange. The Seventh Circuit reversed the SEC order granting clearing agent registration for an electronic system for trading options on government securities. [45] The victory, however, was short-lived. On remand, the SEC ruled that the agent did not have to register as a securities exchange and reaffirmed its earlier position that it could be registered as a clearing agent. [46]

As discussed more fully in a later chapter of this treatise, [47] there have been repeated assaults upon the CFTC's exclusive jurisdiction over futures contracts. The 1987 market break and allegations of wrongdoing at certain commodities exchanges have led to many proposals for change. In 1990, the President recommended that jurisdiction over stock index futures be transferred from the CFTC to the SEC. [48] Some observers have called for merging the CFTC with the SEC or, alternatively, giving the SEC oversight responsibility with respect to the CFTC's jurisdiction over financial futures and options. A less ambitious approach was contained in the proposed Market Reform Act of 1990 that was pending before the Senate [49] but was not enacted. The Futures Trading Practices Act of 1992 allocated hybrid instrument jurisdiction to the Commission if 50 percent or more of a security's value or change in value is attributable to the commodity component. [50] As enacted, the Futures Trading Practices Act of 1992 maintained the status quo pending further study of hybrid derivatives. In October 1993, the Commission issued its study. [51] Amendments to the Act in the year 2000 eliminated CFTC jurisdiction over hybrid securities, even when offered to the general public, if full payment for the instrument is made at or near the outset, no further payment obligation exists, routine mark-to-market margining is not conducted, and the instrument is not marketed as a futures contract (or option thereon). [52]

In a reversal of prior law, the Commodity Futures Modernization Act of 2000 (CFMA) [53] permits the trading of futures contracts on single stocks and narrow-based security indexes. However, the Act retains a distinction between broadly-based and narrow-based indexes. [54] The Shad-Johnson Accord's ban on individual equity-based futures contracts was lifted. Security futures products now may be traded on either securities or commodities exchanges. The CFMA, in establishing this co-regulatory system, directed the SEC and CFTC to coordinate their regulatory oversight over security futures products. For example, the SEC and CFTC adopted joint rules governing margin requirements for security futures products. [55]

[B] Exemption and Exclusion for Hybrid Transactions

In 1993, the Commission revised its exemption for hybrid transactions. This exemption was similar to the proposals for legislative reform made in 1991. The Commission provided an exemption for hybrid investment instruments that meet the following qualifications. [56] First, in order to qualify for the exemption, the instrument must either be (a) an equity or debt security as defined by section 2(a)(1) of the Securities Act of 1933 or (b) a demand or time deposit of certain financial institutions. [57] Second, the commodity-dependent components of the instrument's value must be less than the commodity independent value. [58] Third, the hybrid must be sold pursuant to federal or state securities laws or banking laws and only to those persons thereby permitted to purchase the instrument. [59] The exemption is available only when (i) the issuer receives full payment of the purchase price, (ii) the instrument is not marketed as a commodity option or futures contract, except as necessary to comply with applicable disclosure requirements in describing the instrument's attributes, and (iii) settlement is not made in the form of a delivery instrument specified as a delivery instrument by the rules of a contract market. [60] If the foregoing requirements are met, the exemption is virtually a complete one, including exemption from the Act's antifraud and antimanipulation provisions. [61] The exemption for hybrids does not extend, however, to section 2(a)(1)(B) 's [62] provisions relating to the Commission's jurisdiction. [63]

The Commodity Futures Modernization Act of 2000 (CFMA) [64] allows the offer and sale, to the general public, of various securities or instruments that have behavioral characteristics akin to futures. To qualify for the statutory hybrid instrument relief from the Act's exclusive CFTC jurisdiction, the investment instrument must be predominantly a security. [65]

[C] Former Exemption and Exclusion for Swap Transactions; Regulation Under the Dodd-Frank

Swap Transactions Prior to July 2010

Until July 2010, the Act contained both an exemption and exclusion for over-the-counter swap transactions. That changed when the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandated regulation of most over-the counter swap transactions. [65.1] This new regulatory framework requires the adoption of implementing rules by the CFTC and SEC in order to give effect to the statutory design. The discussion that follows describes the former regime and then gives a brief overview of the new regulation.

The 1992 amendments to the Commodity Exchange Act recognized that not all swap agreements would be subject to the Act and, at that same time, authorized the Commission to provide exemptions for those swaps that are subject to the Act. [66] The amendments authorized the Commission to exempt swap transactions "that are not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the Act." [67] The definition of what constitutes a swap transaction is incorporated by reference from the bankruptcy code. [68] The swap transaction exemption covers a wide variety of institutional and commercial swap transactions but does not operate as a complete laissez-faire approach to over-the-counter swap transactions. [69] The exemption does not, however, provide a haven from the antimanipulation or antifraud provisions of the Act. [70] Until the Commodity Futures Modernization Act of 2000, [71] former section 2(a)(1)(B) 's jurisdictional provisions continued to apply to exempt swap transactions. [72]

The CFTC regulations exempt swap transactions between specified eligible swap participants. The Regulation lists the following eligible participants: (i) banks and trust companies (acting for themselves or for other eligible swap participants); (ii) savings associations and credit unions; (iii) insurance companies; (iv) investment companies registered under the Investment Company Act of 1940 and foreign entities performing similar functions (provided that the investment company is not formed solely for the purpose of entering into swap transactions); (v) commodities pools regulated by the Act and foreign entities performing similar functions (provided that the pool has more than $5 million in assets and was not formed solely to qualify as an eligible swap participant); (vi) certain business-related transactions by other entities; [73] (vii) employee benefit plans subject to ERISA, or similar foreign entity, having more than $5 million in assets or whose investment decisions are made by a bank, insurance company, trust company or investment adviser subject to the Investment Adviser Act of 1940, or a commodity trading advisor subject to the Commodity Exchange Act; (viii) governmental entities and their political subdivisions; (ix) securities broker dealers subject to regulation under the Securities Exchange Act of 1934 and foreign persons performing similar functions (broker dealers that are natural persons or sole proprietors must also meet the requirements of either subsection (vi) or (xi)); (x) futures commission merchants, floor brokers, and floor traders registered under the Act (as well as foreign persons performing similar functions), provided that such commodities professionals, which are individuals or sole proprietorships, must also meet the requirements of either subsection (vi) or (xi); and (xi) natural persons with total assets in excess of $10 million. [74]

The exemption is further limited to three additional conditions: (1) the swap must not be part of a fungible class of agreements having standardized material economic terms, [75] (2) the creditworthiness of any party obligated under the swap agreement must have been a material consideration in entering the agreement or in determining its terms, [76] and (3) the exemption is not available for swap transactions through a central clearing facility. [77]

The Commodity Futures Modernization Act of 2000 (CFMA) [78] allows eligible contract participants to engage in swap transactions involving any asset class other than agricultural products. As a consequence, when a transaction was properly formulated as a swap on financial (excluded) commodities, negotiated between eligible participants and not traded on a trading facility, the CFTC had no residual or reserved jurisdiction. [79] This was changed by the Dodd-Frank Act.

As discussed in a subsequent section of this treatise, [79.1] the Dodd-Frank Act mandates regulation of swap transactions. The Act sets forth a broad definition of swap transactions. [79.2] There are several exclusions from the definition of swap including futures contracts, options on futures contracts, "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." [79.3] In addition to the statutory exclusions from the definition of swap, a new section 1b of the Act leaves to the Secretary of the Treasury the decision of whether to exempt foreign exchange swaps and foreign exchange forward contracts from the definition of swap. [79.4]

[D] The Jurisdictional Accord Reconsidered

The emergence of new trading instruments in the latter part of the twentieth century raised issues concerning whether the 1982 jurisdictional accord is still adequate to assign jurisdiction between the CFTC and the SEC. However, the premise of the Accord that any device that constitutes a futures contract will be CFTC-regulated can work in the current environment as well as in the past if a decision maker is motivated to make the necessary analysis. Thus, all manner of investment instruments that have the economic features of a futures contract would fall within the CFTC's purview; all others would not. The 1992 legislation, however, allows this analysis to be sidestepped entirely, at least for the purposes of granting exemptions. In effect, although the logic of the accord remains workable, it is not being allowed to operate for many of the newer instruments. [80] Although the CFMA clarified the treatment of hybrid instruments, it did not clarify the theoretical differences between commodities-based jurisdiction of the CFTC and securities-based jurisdiction of the SEC. Rather, the CFMA represents an attempt at a pragmatic compromise regarding the allocation of trading between the commodities and securities markets and a correlative division of jurisdictional authority of the two regulatory agencies.

[E] Hybrids and Swap Agreements Under the CFMA

The CFMA reinforces the law existing at the time of its enactment to the effect that the SEC does not have jurisdiction over non-security-based swap agreements. [81] Further, the SEC has only limited jurisdiction over security-based swap agreements. Security-based swap agreements are excluded from the securities laws' definition of security. [82] However, security-based swap agreements are subject to the securities laws antifraud provisions. [83] As a result, the SEC has only limited authority to regulate insider trading, fraud and market manipulation regarding security-based swap agreements.

Swap agreements and certain hybrid instruments that are defined in Title II of the Gramm-Leach-Bliley Act [84] are excluded from CFTC regulation under the Commodity Exchange Act. The hybrid instruments that are excluded from CFTC regulation include deposit accounts, banker's acceptances, letters of credit, debit accounts arising from credit cards, and loan participations. [85] Also excluded from CFTC regulation are banking products which were not prohibited by the Commodity Exchange Act that a banking agency had certified as being offered in the United States by a bank before December 5, 2000. [86] The CFMA excludes from the Commodity Exchange Act hybrid instruments that are predominantly banking products. A hybrid instrument is considered predominantly a banking product if the issuer received payment in full of the purchase price contemporaneously with delivery of the hybrid instrument, the purchaser or holder is not required to make any payment in addition to the purchase price, the issuer is not subject to marked-to-market margin requirements, and the hybrid instrument is not marketed to contract or sale of a futures contract. [87] The Act gives the CFTC the discretion to exclude from Commission regulation other non-predominate banking products. The CFMA further provides that the Commodity Exchange Act should not apply to a "covered swap agreement" offered or entered into by a bank. [88] Covered swap agreements include a swap agreement based on a commodity other than an enumerated agricultural commodity that is entered into between eligible contract participants and is not entered into or executed on a trading facility. [89]

The CFMA contains a preemptive provision respecting hybrid derivatives that are excluded by the Act. Specifically, state anti-bucket shop laws and gambling laws are preempted but state antifraud laws of general application are not preempted. [90]

[F] Derivatives and the Securities Laws [90.1]

The federal securities laws define “security” broadly in a way that includes some derivatives within the statutory category of “investment contracts.” [90.2] One element of an investment contract is a “common enterprise.” [90.3] The majority of derivatives are bilateral contracts and thus do not involve the common enterprise that is required under the applicable law. For the most part, these exotic derivatives are not subject to regulation as securities because they involve contracts between the creator and the investor where the gains of one are the losses of the other; thus, swaps and the like do not involve a common enterprise. [90.4] Although promoters of these derivative instruments put substantial efforts into their design and marketing, standing alone, this is not sufficient to classify them as securities. [90.5] Accordingly, unless the investment underlying the derivatives contract is itself a security, a derivatives contract will not be a security.

A federal district court errantly held that “synthetic” stock transactions [90.6] do not fall within the statutory definition of security but the Second Circuit quite properly reversed this holding since the synthetic stock had all of the attributes of a more traditional investment security. [90.7] For similar reasons contracts for difference that are popular in the U.K. [90.8] are securities under the federal securities laws if their value tracks the value of the underlying common stock. [90.9]

As part of the Commodity Futures Modernization Act of 2000 (CFMA) Congress amended the securities and commodities laws regarding hybrid investments. [90.10] Among other things, these amendments resulted in securities-based swap agreements being excluded from the definition of security but nevertheless subjected to the securities laws antifraud provisions. [90.11] Also, the CFMA expressly provides that swaps that are not security-based do not fall within either the registration or antifraud provisions of the securities laws. Furthermore, there is authority to support the proposition that the CFMA does not preclude the states from regulating swap transactions as securities. [90.12]

Although not securities, equity based swap arrangements may be treated like securities for some purposes in addition to the securities antifraud provisions. Equity swaps, like other equity-based derivatives, can be used for various hedging strategies. They can also be used to acquire potential voting control without retaining actual ownership of the underlying stock. This decoupling of ownership and voting control through the use of equity swap arrangements has been an increasingly popular device used by hedge funds to try to garner more voting power without making the total investment necessary for outright stock ownership. [90.13] In *CSX Corporation v. Children's Investment Fund Management (UK) LLP* , [90.14] the court held that someone with a long position in a cash settled equity swap regarding shares in a publicly held company had filing obligations under section 13(d) of the Securities Exchange Act of 1934 [90.15] which applies to owners of five percent or more of a class of equity securities since the swap agreements were part of a plan to evade the filing requirements. [90.16]

[G] Jurisdiction Over Energy Contracts

Assaults on the CFTC's exclusive jurisdiction over activity on designated contract markets are rare but, as discussed elsewhere in this treatise, occur from time to time. In 2007, the Federal Energy Regulatory Commission ("FERC") invoked an anti-manipulation provision in the Energy Policy Act of 2005 ("EPA") [90.17] to initiate an enforcement action against Amaranth Advisors LLC and related entities [90.18] for manipulation of natural gas *futures* prices on the New York Mercantile Exchange ("NYMEX"), citing the existence of a "nexus" between physical natural gas prices—to which the EPA seems clearly to apply—and the futures prices reported by NYMEX for its natural gas futures contract. The FERC asserted that, because futures markets can impact physical trade in a commodity, it can seek sanctions under the EPA for having indirectly harmed physical gas prices through misconduct on a CFTC-designated contract market like NYMEX. In 2009, FERC approved a settlement that included a $7.5 million civil fine in the *Amaranth* enforcement action. [90.19] Following the FERC settlement, FERC upheld an Administrative Law Judge's decision finding that Brian Hunter, a former Amaranth natural gas trader, had violated the Natural Gas Act, and imposed a $30 million fine based upon a finding of manipulation of the gas-futures market. [90.20] In his petition to the U.S. Court of Appeals for the District of Columbia, Hunter argued that FERC lacked jurisdiction because his actions were in the natural gas futures market. [90.21] The CFTC intervened in the case on appeal and sided with Hunter, claiming that it had exclusive jurisdiction over futures transactions. In March 2013, the D.C. Circuit held that the CFTC has exclusive jurisdiction over natural gas futures contracts and that FERC had exceeded its authority when it fined Hunter. [90.22] Similarly, the CFTC entered into a consent order settling its own charges against *Amaranth*, requiring that the *Amaranth* entities pay a $7.5 million civil monetary penalty and permanently enjoining *Amaranth* from violating the anti-manipulation provisions of the Commodity Exchange Act. [90.23] The CFTC proceedings against Hunter were stayed until resolution of the related FERC litigation. [90.24] With the jurisdictional dispute now resolved, the CFTC will likely restart its suspended enforcement action against Hunter.

In 2008, many commodity markets experienced violent price swings that were attributed by some observers (though not at the time by the CFTC) as the result of "manipulation" by very large speculative traders such as hedge funds and pension plans that were eager to diversify their portfolios beyond securities (a market then also in turmoil, and declining unlike the booming commodity exchanges). Numerous bills were introduced in the Congress testing various remedies, reforms or restructurings to address these concerns. Although none was passed, the CFTC sharpened its focus on the role of large investment vehicles in these markets [90.25] and the Federal Trade Commission ("FTC"), an antitrust and consumer protection agency, also announced that it would propose a new rule of sufficient breadth that it might authorize actions under its own statutes against price manipulations occurring in futures contracts traded on CFTC-designated contract markets.

Citing the Energy Independence and Security Act of 2007 ("EISA") [90.26] the FTC formally proposed to adopt an anti-manipulation rule for crude oil, gasoline and distillates using a standard identical to that which is employed by the Securities and Exchange Commission ("SEC") in its antifraud Rule 10b-5 [90.27] relating to a "manipulative or deceptive device or contrivance" as set forth in the EISA. [90.28] And the FTC affirmatively acknowledged that "trading practices in physical *or futures* markets would also be covered if the conduct met all the elements of a cause of action" (emphasis added). [90.29] Indeed, in its rule proposing release, the FTC asserts that "CFTC authority over manipulation relating to commodities *futures markets* is not exclusive" (emphasis added) and cited approvingly the FERC's position in the Amaranth Advisors proceeding. [90.30] Not only could such an outcome invite scores of new regulators into the futures arena, creating cost, confusion, and conflicting policies that would deeply harm the nation's futures markets, but use of the SEC's antifraud standards which are substantially easier to meet than those of the CFTC for manipulative conduct would encourage cherry-picking of statutes by agencies and private plaintiffs alike to find the path of least resistance to their goals. [90.31]

Section 720 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires the CFTC and FERC to negotiate a memorandum of understanding “resolving conflicts concerning overlapping jurisdiction,” a phrase which implied that FERC may have authority in areas assigned to the CFTC. [90.32] In January 2014, the FERC and CFTC signed two Memoranda of Understanding (“MOU”) to address jurisdictional and information-sharing issues. The jurisdictional MOU does not in fact address the two agencies' jurisdictional boundaries but, rather creates a procedure under which the agencies will notify each other of activities that may involve overlapping jurisdiction and coordinate to create an approach that satisfies both agencies' regulatory concerns. [90.33] The information-sharing MOU establishes procedures for sharing of information and for assuring the confidentiality of shared information. [90.34] The MOUs allow the agencies to promote effective and efficient regulation to protect energy market competitors and consumers. In March 2014, the CFTC and FERC announced the initial transmission of market data under the information-sharing MOU for use in analyzing market activities and protecting market integrity. [90.35] They also announced the creation of a staff-level Interagency Surveillance and Data Analytics Working Group to coordinate information sharing between the agencies and focus on data security, data-sharing infrastructure, and the use of analytical tools for regulatory purposes. [90.36]

In addition, section 722 of the Dodd-Frank Act appears to award FERC regulatory jurisdiction over transactions (including some types of commodity interests subject to CFTC oversight) that are entered into pursuant to a FERC-approved tariff or rate schedule under either of the following conditions: (1) if not conducted on a registered entity or trading facility, or (2) if conducted or cleared on a registered entity or trading facility owned or operated by an independent system operator (“ISO”) or a regional transmission organization (“RTO”).

In March 2013, the CFTC adopted a final order that exempts from certain provisions of the Act and CFTC regulations certain specified transactions of Regional Transmission Organizations and Independent System Operators that are subject to regulation by either FERC or the Public Utility Commission of Texas (“PUCT”). [90.37] The final order exempts the purchase or sale of specifically defined “financial transmission rights,” “energy transactions,” “forward capacity transactions,” and “reserve or regulation transactions” that are offered or sold in a market administered by one of the petitioning RTOs or ISOs pursuant to a tariff or protocol that has been approved or permitted to take effect by FERC or PUCT. At the same time, the CFTC adopted a final order that exempts certain non-financial energy derivative transactions between and amongst government-owned electric utilities and cooperatively owned electric utilities from most of the requirements of the Act, [90.38] recognizing that the entities eligible for the relief have a unique public service mission of providing their customers with reliable, affordable electric energy service. The transactions covered by the final order are entered into for the primary purpose of managing supply or price risks arising from current or anticipated public service obligations to physically generate, transmit, and deliver electric energy service to customers. The exemptions under both final orders are subject to certain conditions and the CFTC's antifraud, antimanipulation, and scienter-based prohibitions will continue to apply.

[3] The Futures Contract

Unlike the term *commodity*, no definition of futures contract appears in the statute. The phrase that most commonly appears in the Act is "contract of sale of a commodity for future delivery." [91] Because the meaning of commodity has already been discussed, [92] attention focuses on the two phrases *contracts of sale* and for *future delivery*.

Section 1a of the Act defines contracts of sale as "sales, agreements of sale, and agreements to sell." [93] The words *future delivery* are not affirmatively defined, but section 1a excludes from their meaning "any sale of a cash commodity for deferred shipment or delivery." [94] Thus, a contract of sale appears to embrace any form of sales arrangement, but the phrase *future delivery* eliminates transactions where an immediate sale occurs but where, for the convenience of the parties or otherwise, the actual transfer of the commodity is deferred. The primary focus of this exclusion, in historical context, was on a common practice in agricultural trade of making binding sales with postponed delivery; these arrangements frequently are referred to as *forward contracts.* For example, grain merchants would often commit to buy a portion of farmers' plantings in advance of harvest. The sales price was fixed immediately, both parties contemplated that the grain or produce would eventually be transferred, but delivery would have to await harvesting. In most cases, the commitment was personal to the parties, and the obligation to deliver could be excused only with the other party's consent.

Subsequently, the Commission shifted its attention in analyzing forward contracts away from the frequency of delivery or performance and toward whether the transaction creates a legally enforceable right to make or take delivery, with no initial agreement to substitute cash instead. [95] The courts have also contributed to the definitional issue. For example, the Seventh Circuit has noted that a contract will be deemed a forward contract if: (1) it sets forth specific terms, so that it is not fungible with other contracts for the commodity; (2) the parties are industry participants rather than speculators; and (3) delivery cannot be deferred indefinitely without the seller incurring additional costs. [96]

Although futures contracts are not defined with particularity in the Act, business usage permits a general description to be made. This description, however, is not intended to exclude other arrangements of comparable nature, and the CFTC has made clear its intent to construe very broadly the meaning of the phrase "contracts of sale of a commodity for future delivery." [97]

The traditional futures contract is an agreement between a seller and a buyer that the seller (called a short) will deliver to the buyer (called a long), at a price agreed to when the contract is first entered, and the buyer will accept and pay for, a specified quantity and grade of an identified commodity during a defined period in the future.

For reasons discussed later in this chapter, [98] traditional domestic futures contracts can be acquired lawfully by the general public only on the designated contract markets. The contracts, in fact, are designed and sponsored by the commodities markets where they are traded. A key feature of these futures contracts is their standardized, uniform terms. [98.1] Thus, for example, a corn futures contract designed and sponsored by the Chicago Board of Trade calls for the delivery of No. 2 (grade) yellow corn in the quantity of 5,000 bushels during one of a number of specified future months. Similarly, financial futures may call for cash settlement based on a predetermined formula. Thus, for example, a full-scale stock index future based on the Standard and Poor 500 Stock Index sponsored by the Chicago Mercantile Exchange calls for the delivery of cash based on the index number times $500 during one of a number of specified future months. The terms of a futures contract are not negotiable between the parties; they must be accepted by both. [99] The only item open to negotiation is the contract's *price*, [100] which is established through competitive bidding on the exchange floor or electronic trading facility. The sponsoring market also sets the procedures for delivery: where, when, and how. If variations in quality (grade) are allowed, it is the exchange—not the parties—that fixes applicable price premiums and discounts.

Although futures contracts frequently have standardized terms, standardization is not essential. [101] Even in the absence of standardized terms, a contract contemplating a deferred delivery will be categorized as a futures contract when there is an implicit guarantee by the seller that it will provide the opportunity for an offsetting transaction in lieu of delivery. [102]

A futures contract is to be distinguished from a cash transaction involving the underlying commodity. [103] Spot market transactions are not presently subject to regulation under the commodity laws (other than for price manipulations and certain position limits) even if they are entered into for speculative purposes. [104] Thus, for example, a computerized trading system designed to handle contracts contemplating actual delivery in connection with foreign currency spot transactions is not subject to CFTC regulation as a contract market. [105] The absence of contract market trading can mean, however, that foreign currency instruments are unregulated. The Second Circuit once held that off-exchange foreign currency options were subject to CFTC subject matter jurisdiction. [106] The Treasury Amendments to the Act exclude "transactions in foreign currency" but the court held that this phrase did not exclude *options* in foreign currency. [107] The court further acknowledged that this interpretation was in conflict with the Fourth Circuit's approach [108] but that it was consistent with the Second Circuit's earlier ruling in the *American Board of Trade* case. [109] The Second Circuit explained that it would not reject its earlier view of the meaning of the Act and that if the conflict with the Fourth Circuit was to be resolved, it should be by the Supreme Court. The Supreme Court accepted that invitation and soundly reversed the Second Circuit. [110] The Court reasoned that both the clear language of the Treasury Amendment and the legislative history supported a broad reading of the exclusion from Commission jurisdiction for all off-exchange transactions in foreign currency, including options transactions.

The Commodity Futures Modernization Act of 2000 further resolved the judicial debate over regulation of foreign currency transactions by maintaining an exclusion for activity conducted between certain institutions and high net worth individuals but restoring CFTC oversight of forex transactions marketed to the general or retail public, [111] as well as those which are conducted on an organized exchange. The CFMA amendments also make clear that, in the retail arena, the CFTC's reach extends to *options* as well as futures contracts. [112]

The importance of exchange sponsorship of futures contracts cannot be overstated. It permits the development of uniform contracts that would be impossible through private negotiation. It makes possible the design of contracts of maximum utility to commercial firms seeking price hedging protection or a useful reference point for commercial pricing decisions. [113] It brings certainty to the understanding between the parties. And, of great importance, it achieves the fungibility of contracts necessary to engage in oyffset, a procedure that is discussed in the next section.

[4] The Offset Process

Futures contracts create a right of the seller (short) to deliver the actual commodity at the appointed time, as well as a right of the buyer (long) to demand that delivery, but parties rarely exercise that right. Instead, approximately 95 percent of all futures contracts are extinguished through a market operation called *offset.* Under this procedure, a party to a contract will enter the market a second time to acquire the same type of contract but bearing an obligation opposite to his first transaction. For example, a party whose first contract is to buy corn for delivery in a given period (e.g., November) will acquire a second contract to sell corn for November delivery, thus assuming equal and opposite obligations. These two transactions are said to offset each other, and the party is excused from both obligations. If a market price movement has occurred between the first and second transactions, however, so that different contract prices are involved, offset will not be complete until the money difference is settled.

Offset is also available on the organized exchanges for futures contracts that, by their terms, call for cash payments at maturity rather than physical transfer of an asset. For example, stock index futures are *required* by the Act to be settled only in cash. [114] Thus, even where the futures contract will ultimately be satisfied by a cash payment in any event, offset may be used to accelerate the transaction's completion at the then-prevailing price.

Whether the offsetting party will be required to pay the price difference, or will be entitled to receive money, depends on the nature of his first contract and the direction in which market prices have moved in the period between the first and second transactions. If, for example, the party's first contract was to *buy* corn, and a market *decline* occurs prior to the second transaction, he will be required to pay the difference. This is because the party has agreed (in the second transaction) to *sell* the same commodity at a price below his cost of buying it in the first trade, resulting in a loss. Had the party's first contract been to *sell* corn, and prices subsequently fell, on the other hand, his cost in the second transaction (to *buy*) would be below the price at which he was committed to sell the same commodity, resulting in a profit that he is entitled to receive on offset.

Offset simulates the economic consequences that would have occurred if delivery had actually taken place at the time of the second counter transaction. It is important to note, initially, that futures prices and cash market prices tend to follow similar patterns. When the futures market experiences a significant price change, the prices of that commodity in the cash market will usually experience a similar movement. In the examples above, if the party's first contract was to buy corn, and if the market price of that corn had declined subsequently, he could take delivery of the corn at the higher contracted price and face the unhappy prospect of selling it in the lower current cash market. On the other hand, if the party's first contract was to sell corn, and if prices then fell, he could deliver by entering the current (lower-priced) cash market, acquire the necessary quantity of corn, and tender it to the buyer at the higher contracted price.

Offset has been upheld in the courts as a lawful means for the settlement of futures contract obligations [115] and is the manner in which the vast majority of futures contracts are satisfied.

The fungibility of futures contracts is vital to an effective offset procedure. Were it not possible to acquire an *identical* (though opposite) contract, different obligations or rights might arise in the second transaction that would preclude the mutual discharge of the two contracts. In addition, offset is possible only if a party may freely acquire the opposite contract in the market, without regard to whether the second transaction is effected with the same person as the first. For this reason, among others, the organized commodities exchanges maintain central clearing houses where, once a contract is made, the clearing house substitutes itself for the direct parties, eliminating any need for a prospective offsetter to search out his original counterpart. In effect, the party has made *both* trades with the clearing house and, accordingly, offset occurs.

[5] Identifying a Futures Contract

Absent a clear statutory definition of what a futures contract is, it remains extremely difficult to determine whether a particular instrument, offered or sold without the intercession of a contract market or the benefit of a statutory exemption or exclusion, offends sections 4, 4b, and 4h. The staff of the CFTC, however, has declared its intent to view as a futures contract any agreement for the future delivery of a commodity, with a narrow exception for "the class of commercially motivated cash commodity sales, which contemplate actual delivery of the commodity, but in which delivery may be deferred for purposes of commercial convenience or necessity." [116] A futures contract is generally premised on a future delivery at a specified price. [117] However, given the extensive definitional provisions added to the Act by the Dodd-Frank Act, the exclusions from the futures contract definition are now more numerous, more important, and more clearly defined than previously.

The Commission addressed the question of what a futures contract is under the Act in *In re Stovall*, [118] an administrative action before the Commission seeking a declaration that Stovall's offerings to the public were futures contracts purveyed in violation of the Act. On this issue, the complaint against Stovall appears to have relied entirely on section 4 of the Act, [119] which, as noted later, [120] prior to 1983 applied by its terms only to the private vending of futures contracts that were "on or subject to the rules of" a contract market. Stovall, a member of the Chicago Board of Trade, was accused of creating his own futures contracts and of offering them privately. The Commission, affirming an earlier ruling by an administrative law judge, found that Stovall's instruments were within the Act's perception of a futures contract. It rejected Stovall's plea that his offerings were sales of "cash commodities for deferred delivery" subject to the exemption contained in section 1a of the Act. [121] In support of this finding, the Commission cited several features of the Stovall program that, in its view, disqualified those instruments from the exemption: (1) they were standardized agreements; (2) they provided for future delivery of a commodity; (3) they were offered to the general public; and (4) they were secured by earnest money or "margin." [122] The Commission also observed that Stovall's customers, unlike parties to bona fide cash transactions, had no expectation that delivery of the commodity would actually occur but rather, as in futures trading, sought to profit from favorable changes in commodity prices. [123] Indeed, the Commission found from the record that, with one limited exception, all Stovall customers concluded their transactions by offset with Stovall. [124] Notwithstanding this recitation of futures contract attributes, the Commission sounded the following warning:

> We do not mean that all commodity futures contracts must have all of these elements, nor are the elements we have described here an exhaustive catalogue of factors to which we will look in every case to determine whether an instrument is a cash contract for deferred shipment or delivery, or is a commodity futures contract. Rather, we will look at each operation in context and will not hesitate to look behind whatever label the parties may give to the instrument. [125]

In response to Stovall's contention that section 4 of the Act had not been violated because his contracts were privately created and thus were neither "on" nor "subject to the rules" of a contract market as recited in that section, the Commission responded with what was essentially a policy argument rather than a direct legal rebuttal. Although the Commission cited legislative history of the original Act as evidence of a congressional intent to ban all off-exchange futures contracts, [126] it did not explain away the "on or subject to the rules" language of section 4. Rather it rejected "unequivocally" [127] the Stovall argument on the ground that, if adopted, it would "undercut the central purpose of the 1922 legislation" and "leave untouched any private exchange or bucket shop operation." [128] That conclusion is open to debate, however, since section 4h of the Act —which was not invoked in *Stovall* for unknown reasons—prior to amendment in 1983 would have been available to check purely private futures programs (at least when not executed through contract market members). [129]

Following the lead of the *Stovall* decision, the CFTC and the courts have identified factors traditionally associated with futures, as opposed to largely unregulated forward contracts. [130] Designation in the contract does not dictate whether a contract is a "forward" or a "futures" contract. As noted above, standardization of terms is a significant factor in finding a futures contract. [131] The customer does not expect to take delivery. [132] The futures contract customer generally has no business use for the commodity. [133] It is to be recalled that other attributes bear on the existence of a futures contract. Typically, the customer can take a "long" or a "short" position and controls the position with a deposit. [134] The customer who does not have an obligation to make or accept delivery (except in the case of cash-settled instruments) probably is not dealing in a futures contract. [135] It is also important to remember that dealing in futures is distinct from a contract relating to forward trading of the physical commodity. [136]

The CFTC broadly construed the statutory definition in differentiating between forward contracts, which need not be traded on a designated contract market, and futures contracts, which must be, in the absence of an exclusion or exemption under the Act or CFTC rules. [137] The more recent CFTC policy has de-emphasized the frequency of actual delivery under forward contracts for a review of whether a right to make or take delivery is legally enforceable and where offset or cash settlement may be refused by either party. [138] While the lack of expectation of delivery is a most significant factor, [139] the traditional factors outlined above continue to remain applicable in evaluating whether a particular arrangement is in fact a futures contract.

The Ninth Circuit had the opportunity to revisit the difference between a futures contract that is subject to the Act and a forward contract that is not. [140] When actual delivery is contemplated but the obligation is deferred because of commercial convenience or necessity, the forward contract exclusion will be applied. [141] The court applied the exclusion for forward contracts because the parties to the contract in question respectively "had the legal obligation to make or take delivery upon the demand of the other." [142] As explained in another decision, even the fact that a contract was entered into for speculative purposes will not render it a futures contract if it does not meet the statutory criteria. [143] In its rulemakings implementing the Dodd-Frank Act swap and retail commodity contract amendments, the CFTC has extensively considered the scope of the forward contract exclusion, as discussed more fully in § 1.02[8].

The critical inquiry is to look at all of the surrounding circumstances in light of the Act's purpose. [144] The ultimate determination of whether a futures contract exists is thus highly factual. [145]

Finding a contract to be a futures contract is not the only way to subject it to the jurisdiction of the Commodity Exchange Act. Contracts for deferred delivery may alternatively be classified as leverage contracts, [146] which are prohibited unless they relate to bullion and are in compliance with CFTC requirements. [147] Similarly, a contract may properly be classified as a commodity options contract, [148] which is prohibited unless traded on a contract market or in compliance with the CFTC commodity option dealer regulation [149] or subject to exceptions or exemptions allowed by the CFTC or the Act. [150] Additionally, hedge-to-arrive contracts may be characterized as futures contracts, especially if the contracts permit unlimited rolling over to new contracts. [151] On the other hand, hedge-to-arrive contracts that do not have unlimited rollover features can qualify as bona fide forward contracts. [152] The expectation of actual delivery is the key to determining whether a hedge-to-arrive contract is a futures contract subject to the Act or a forward contract which is not (except for the Act's prohibition against price manipulation). [153] The question is not whether actual delivery takes place but whether delivery is contemplated in setting the terms of the contract. [154] This determination often becomes a factual one [155] but most of the cases have found that most parties to hedge-to-arrive contracts (HTAs) contemplate delivery and thus those HTAs are forward contracts rather than futures contracts. [156] Even with futures contracts delivery may be contemplated by the terms of the contract but the real question is the actual investors' expectations. [157] Although, as noted above, rollover features can be compatible with the delivery requirement generally associated with futures contracts, the existence of a rollover is not dispositive. Thus, where the circumstances of the case demonstrate that actual expectations were not those normally associated with regulated futures rather than unregulated forward contracts, then the commodities laws are not implicated. [158]

As discussed elsewhere in the treatise, [159] there has been a continuing deterioration of the contract market monopoly. Hybrid instruments have raised difficult questions concerning their classification as futures contracts or as securities. [160] In January 1989, the Commission issued a statutory interpretation recognizing an exclusion from regulation for certain futures-type hybrid instruments that are debt securities under section 2a(1) of the Securities Act of 1933 [161] or are time deposits [162] that are offered by a bank belonging to the Federal Deposit Insurance Corporation, provided that these products are marketed and sold directly only to bank customers. [163] Under the Commission's statutory interpretation, hybrid debt or depository instruments are excluded from regulation under the Act only if they meet stated criteria. [164]

At the same time, the Commission proposed regulations to exempt certain additional options-type hybrid instruments from regulation. [165] The proposed regulations were adopted in July 1989. [166] The new rules (known as the option hybrid exemption) were not intended to resolve completely the issue of whether hybrid instruments should be regulated by the Commission but rather were in response to an expressed interest in exempting certain categories of hybrid debt investments. [167] As originally proposed, the rules would have exempted hybrid financial instruments, such as debt instruments with limited option components, based on deference to other regulatory schemes. [168] As adopted, the exemption was expanded to apply equally to preferred stock and other preferred equity interests that meet the criteria. [169] Following the criteria set forth in its earlier statutory interpretation, [170] hybrid debt, preferred equity, or depository instruments, [171] the yield of which is commodity-based, [172] were not subject to Commission regulation if the value of the implied option premium [173] was no greater than 40 percent of the instrument's issue price [174] and the issuer met certain solvency criteria. [175] Additionally, the instrument could not be marketed as a futures contract, except to the extent necessary to comply with applicable regulatory requirements, [176] nor provide for settlement in the form of delivery instrument also used by contract markets. [177] When the commodity-based index was computed with reference to prices reported on a contract market, the exemption was conditioned on the Commission receiving written notice within five business days of the instrument's offering. [178] In addition, the Commission reserved the power to grant additional exemptions in response to a written petition. [179]

To illustrate, an energy company may issue notes where the interest rates fluctuate depending on crude oil prices. These and comparable instruments offer the investor a taste of the "action" experienced in the futures markets while allowing the issuer to self-hedge by tying its obligations to the economics of its industry at any given time. Where the hybrid instruments are affected by changes in the fortunes of the issuer's business, the risks of economic downturn are greatly moderated, and the need for using traditional futures as a hedge is reduced. Over time, this phenomenon could have a negative impact on the growth of the futures markets.

In April 1990, the Commission issued a revised statutory interpretation concerning hybrid instruments. [180] Under the expanded interpretation, hybrids that may qualify for the exemption now included instruments that combine commodity option or futures characteristics with preferred equity securities. The category of hybrid bank instruments was also expanded. Originally the exemption included only time deposits. The revised interpretation expanded this to include demand deposits as well as transaction accounts. The revised statutory interpretation was available to qualifying hybrid instruments only when the qualifying hybrid instrument: (1) is indexed to a commodity on a basis not greater than one-to-one; (2) has a loss limitation; (3) has a commodity-independent yield of at least 50 percent but not more than 150 percent of the estimated yield at the time of issuance of a comparable non-hybrid instrument; (4) does not have a commodity component which is severable from the debt, preferred equity, or depository instrument; (5) does not call for settlement or delivery by means of a delivery instrument specified in the rules of a designated contract market; and (6) is not marketed as a futures contract or commodity option or as having the characteristics of a futures contract or commodity option, except to the extent that such a description is necessary to accurately describe the investment or to comply with applicable disclosure requirements. [181] As described more fully below, in 1992, the Act was amended by adding section 4(c) which permitted the Commission to formally exempt contracts if, among other things, doing so furthers the public interest. [182]

In 1993, the Commission created a single, general exemption for hybrid transactions. The revised exemption, which was promulgated after the 1992 amendments to the Act, seems more straightforward than its predecessor. The exemption is available for hybrid instruments that meet the following qualifications. First, in order to qualify for the exemption, the instrument must either be an equity or debt security as defined by section 2(a)(3) of the Securities Act of 1933 or a demand deposit or time deposit of certain financial institutions. [183] Second, the commodity dependent components of the instrument's value must be less than the commodity independent value. [184] Third, the hybrid must be sold pursuant to federal or state securities laws or banking laws and only to those persons thereby permitted to purchase the instrument. [185] The exemption is available provided (i) the issuer receives full payment of the purchase price, (ii) the instrument is not marketed as a commodity option or futures contract, except as necessary to comply with applicable disclosure requirements in describing the instrument's attributes, and (iii) settlement is not made in the form of a delivery instrument specified as a delivery instrument by the rules of a contract market. [186] No limitation is placed on the types of investors that may purchase these instruments. [187] The prolonged struggle over treatment of hybrid instruments largely ended with amendments to the Act in 2000, which excludes hybrid instruments from the Act, even in the hands of the general public, if: the full purchase price is tendered at or near inception, no further payments are due, mark-to-market margining is not used, and the instruments are not promoted as CFTC-regulated futures or options on futures. [188]

Swap transactions have become an increasingly popular investment vehicle. [189] The Commission originally adopted the position that although swap transactions have some elements of futures transactions, most swap transactions that are settled in cash are excluded from the Commission's regulations. [190] The Commission's original policy statement created a safe harbor from regulation for cash-settled swap transactions if five conditions were satisfied:

1. The material economic terms of the transaction must be individually tailored;
2. There must be performance obligations that are terminable only on consent of the other party;
3. The transactions must not be supported by a clearing organization or similar entity;
4. The transaction must be entered in connection with the parties' lines of business; and
5. The swap transactions must not be marketed to the public. [191]

In 1993, the Commission exercised its newly-acquired exemptive power to exempt a wide variety of swap transactions. The exemptive regulations are discussed in more detail elsewhere. [192] The Commission exempted transactions only between entities that qualify as eligible swap participants. [193] The exclusive list of eligible swap participants under the Regulation is discussed in an earlier section. [194] The exemption adopted by the Commission provides that exempt transactions are, nevertheless, subject to the Act's antifraud and antimanipulation provisions. Unlike the Commission's 1989 Policy Statement, the use of margining for credit enhancement is no longer prohibited. Nevertheless, the earlier Policy Statement may be relied upon if it is better suited to any particular swap transaction.

The Commodity Futures Modernization Act of 2000 addressed swap transactions by excluding them from virtually all of the Act so long as the parties are eligible contract participants as defined in section 1a(12) of the Act, the agreement is subject to individual negotiation, and no trading facility (as defined in section 1a(33) of the Act) is used to enter or execute the transaction. [195]

Hybridization of investment vehicles continued. [196] A major question, prior to 1992, was whether Congress would enact legislation. The Senate passed a bill that would have taken a "functional approach" in deciding whether a particular instrument is subject to SEC or CFTC jurisdiction. [197] Under the proposed legislation, the appropriate regulatory agency would have been determined by applying a formula based on the instrument's price behavior. [198] Although jurisdictional allocation has become a difficult problem, [199] the proposed legislation might only have further confused the issue. [200] The Senate proposal was not included in the 1992 amendments to the Act. However, as noted above, the 1992 legislation did include a new section 4(c) of the Act which empowers the Commission to grant exemptions if it finds that doing so furthers the public interest. In 1995, the Commission also exempted from registration requirements, risk disclosure rules, trading rules, and reporting requirements certain transactions by professional and institutional traders in qualified exchange-traded products. The impetus behind these exemptive rules was to permit the exchanges to compete more effectively with trading among professionals and institutions in off-exchange products. The exemption was contained in the former version of Part 36 of the Commission's Regulations. [201] The number of off-exchange transactions has increased dramatically. There has been an increase in both the number and variety of over-the-counter derivative products. In May 1998, the CFTC issued a concept release soliciting comments as to whether the Commission should alter its current regulatory approach. [202] This was followed by the Commodity Futures Modernization Act of 2000 [203] which officially recognized as unregulated over-the-counter markets for transactions between qualified large and sophisticated investors as well as transactions between these participants on exempt boards of trade. [204] The current version of Part 36 of the Commission's Regulations exempts transactions between eligible contract participants. [205]

The Commodity Futures Modernization Act of 2000 also created an unregulated over-the-counter market for derivative products traded off-exchange by eligible contract participants. As explained more fully in a later section, [206] section 2(d) of the Act [207] authorizes eligible contract participants to engage in certain bilateral futures transaction either manually or through an electronic trading facility in commodities that are excluded from CFTC regulation under section 1a(13) of the Act. [208]

The foregoing regulatory developments regarding off-exchange instruments should be viewed in the context of the general approach announced by the Commission in a joint statement with the SEC and the U.K. Securities and Investment Board. [209] The joint statement addressed increased regulatory cooperation and announced a seven-point program of cooperation between these three regulatory bodies. First, the regulators are committed to information sharing to improve international oversight of over-the-counter derivatives trading. Second, the regulators announced a commitment to improved risk management by promoting legally enforceable netting procedures. Third, the regulators showed concern over excess leverage and want to promote the establishment of prudent risk-based capital charges and increased use of stress simulations of severe market conditions. This is designed to equip the markets to deal better with volatility. Fourth, the regulators are committed to promoting the establishment of "sound management controls" in order to monitor and control risk and trading activities. Fifth, there is a commitment to strengthening standards for customer protection with regard to off-exchange transactions. Sixth, the regulators are exploring the possibilities for multilateral clearing arrangements for international off-exchange transactions. Seventh, there is a commitment to improved standards for accounting recognition of risks resulting from these derivative investments, as well as measurement and disclosure.

[6] General Exemptive Authority

On many occasions, the absence of a specific definition of either a contract of sale for future delivery or a commodity option has made it difficult to catalogue a particular product. The misallocation of a product can have severe consequences. Under section 4(a) of the Act for example, in the absence of an exemption or exclusion under the Act or CFTC rules, it is unlawful for a futures contract to be executed away from a designated contract market, and in extreme circumstances this could be prosecuted as a felony under section 9(a) of the Act.

Because of this ambiguity, the Commission has been faced with repeated demands for greater certitude. At least two courses of action are available to the Commission. One approach would be to define a futures contract or option in great detail, but such a step could inadvertently exclude some instrument or activity that should properly be subject to regulation. At a minimum, a specific definition would provide a blueprint as to where the boundary is, which might be used by unscrupulous persons to create futures-like or options-like products without regulatory oversight. The other approach for the Commission is to grant exemptions on either a case-by-case or class basis. However, the Commission's exemptive authority under the Act had traditionally been quite narrow. As a result, until 1992 the use of "no-action" letters by the Commission's staff had been the only way in many cases to obtain any relief.

No greater gift can be bestowed by Congress on a regulatory agency than the power to exempt. In 1992, Congress amended section 4 of the Act to create a procedure whereby, in limited circumstances, the Commission may exempt "any agreement, contract, or transaction" and related services from any and all provisions of the Act except former section 2(a)(1)(B). The stated purpose of the exemptive authority is to promote responsible economic or financial innovation and fair competition. [210] Before granting such an exemption, however, the Commission must find that it would be consistent with the public interest and the purposes of the Act, the transaction will be entered solely among "appropriate persons," and the exemption will not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the Act.

The scope of the phrase "appropriate persons" under section 4(c)(2) includes a bank or trust company; a savings association; an insurance company; an SEC-registered investment company; a commodity pool operated by a CFTC-registered commodity pool operator; a business entity with a net worth of $1 million or total assets exceeding $5 million (unless the transaction is guaranteed by certain other appropriate persons); an employee benefit plan with assets exceeding $1 million whose investments are managed by a bank, trust company, insurance company, SEC-registered investment advisor, or a CFTC-registered commodity trading advisor; a governmental entity (foreign or domestic) or a multi- or supranational entity and their departments, agencies, and instrumentalities; an SEC-registered broker-dealer; a registered futures commission merchant, floor broker, or floor trader; and any other persons deemed by the Commission to be appropriate in light of their financial or other qualifications or the applicability of appropriate regulatory protections.

The Commission is not obligated to deem all of the foregoing to be "appropriate persons" but may not expand the list either (except through the final standard above), according to the Committee of Conference. [211] The Commission has tracked these categories in its implementing rules for swaps [212] and hybrid securities [213] and, in the case of swaps only, has also included natural persons with net worths exceeding $5 million or total assets exceeding $10 million. On the other hand, the Commission required in the case of a natural person who is a futures commission merchant, floor broker, or floor trader that he or she must meet the foregoing net worth or total assets threshold for swap transactions, whereas section 4(c) does not contain this requirement.

Section 4(c)(5), as adopted in 1992, requires the Commission to "promptly" consider exemptions for certain swap transactions and hybrid securities. Nevertheless, the Committee of Conference cautioned that its goal is not to prompt "a wide-scale deregulation of markets falling within" the Act and that it is not intended for the Commission to grant broad exemptions for instruments or markets before certain studies (including one ordered by the Committee itself) [214] have been conducted and the Congress has ultimately decided the issues raised by them. [215] While those comments would appear not to apply to the swaps and hybrid securities for which prompt action is urged by section 4(c)(5), it is uncertain what other instruments or markets may be affected and, if so, for how long. In fact, these congressional admonitions had little impact on Commission operations.

Finally, the Conference Committee indicated that it expected the Commission to give due regard to considerations of systemic risk in financial markets. The phrase "systemic risk" is commonly associated with potential "ripple effects" from a breakdown in one segment of the financial sector, such as a major financial default that may trigger others. This has become a very acute concern in the swaps market in particular, because the viability of each transaction is often dependent entirely on the creditworthiness of the counterparties. While the development of a formalized system of clearance, similar to the methods for clearing used in the futures, standardized securities options, and government options industries would greatly reduce this systemic risk, the Commission initially refused to permit such a clearing system to be developed for the swaps business, with pronouncements both before [216] and after [217] the 1992 amendments that it was not yet prepared to exempt such a program without reviewing each clearing proposal.

A change in the Commission's attitude toward formal swap clearing facilities was signaled, however, in a November 1999 report of The President's Working Group on Financial Markets, of which the Commission was a member, with a unanimous recommendation that Congress adopt legislation for clearing over-the-counter derivatives like swaps. [218] Indeed, the Commodity Futures Modernization Act of 2000 achieved that aim by separating, for the first time, the concept of a clearing organization from affiliation with any exchange, thus making possible the creation of stand-alone clearing houses for the swaps community and other OTC users. [219]

Until 2000, however, the Commission conditioned its exemption for swap transactions on the absence of central clearing systems for swap transactions. [220] In adopting those regulations, the Commission did note, however, that it might permit such a central clearing facility in the future. [221] The Commission exempted transactions between entities and individuals that qualify as eligible swap participants. [222] The exclusive list of eligible swap participants under the Regulation is discussed in an earlier section. [223] The exemption adopted by the Commission provides that exempt transactions are, nevertheless, subject to the Act's antifraud and antimanipulation provisions. In 1995, the Commission exercised its authority under section 4(c) to exempt trading by professional and institutional investors of certain exchange-listed products. [224] The driving force behind this exemption was to permit the exchanges to compete more effectively with off-exchange products. In year 2000, the Act was amended to essentially codify this exemption for boards of trade that deal only with eligible contract participants and offer only instruments that are very unlikely to pose a threat of manipulation. [225] Most of these exemptions were eliminated by the Dodd-Frank Act, and the Dodd-Frank Act prohibits the CFTC from granting exemptions from many of the key swap provisions of the Dodd-Frank Act, except as expressly authorized. [225.1] The CFTC has authority to further define certain terms by rule.

[7] The Contract Market Monopoly

Until the year 2000, it was generally understood (although the Act was less than crystal clear prior to 1983) that all domestic "contracts of sale of a commodity for future delivery" had to be executed on an organized commodities market that was "designated" as a "contract market" under the Commodity Exchange Act. [226] This conclusion was reached from an examination of the Act's legislative history and three of its provision: sections 4, 4b, and 4h. In 1921, Congress adopted a Futures Trading Act that would have imposed a prohibitive federal tax on any futures transaction that was not effected on a licensed market. [227] That Act was declared unconstitutional in the following year [228] because of its employment of the taxing power as a regulatory tool. Nevertheless, essentially the same statute was enacted again in 1922 [229] with some changes and was upheld (without the taxing provisions) as a legitimate exercise of Congress's power to regulate interstate commerce. [230] The resuscitated statute, which was renamed the Grain Futures Act, was clearly intended to continue the theme of its ill-fated predecessor, although its text left much to be desired.

Section 4 of the Act, a part of the 1922 statute, pertained to "any contract of sale of any commodity for future delivery *on or subject to the rules of any board of trade in the United States* " (the italicized qualifying language was deleted in 1983). The section declared it unlawful for "any person" to use the mails or other communications method in interstate commerce to (1) offer to make or execute, (2) confirm the execution of, (3) issue quotations or price reports on, or (4) actually make or execute, any such contract unless "such contract is made by or through a member of a board of trade which has been designated by the Commission as a 'contract market.'" [231] The focus of section 4 appeared to be on attempts to "play" the organized markets without actually placing and executing orders there. Enterprises offering this opportunity were commonly referred to as "bucket shops." [232] Bucketing a transaction is one way of describing an uncompetitive trade when the broker takes the other side of a customer's order. [233] Section 4 is not limited to brokers and other commodities professionals. The inclusion of "any person" in the section's prohibition suggests that one need not be engaged in business as such to run afoul of its terms.

Section 4h of the Act, added in 1936, made it unlawful "to conduct an office or place of business anywhere in the United States or its territories for the purpose of" [234] (1) soliciting or accepting orders, (2) making or offering to make, or (3) conducting any dealings in, "any contracts for the purchase or sale of any commodity for future delivery" unless executed or consummated "by or through a member of a contract market." [235] Thus, former section 4h closed the potential loophole originally left by the pre-1983 version of section 4, so that privately created futures contracts were covered. The 1983 amendments reaffirmed the Act's applicability to privately created contracts.

The pre-1983 wording of section 4, read literally, permitted futures trading (in exchange instruments or private contracts) as long as it was effected "by" or "through" a contract market member. However, the bar of former section 4(a) could not be easily circumvented by utilizing exchange members as transaction-makers in a private vending program. At the time of the enactment of section 4(h) in 1936 (section 4(a) 's predecessor), a new section 4b prohibited any contract market member from "bucketing" any order for futures contracts irrespective of whether those contracts were exchange sponsored. [236] Bucketing was understood to mean dealing in futures contracts outside the exchange facilities or withholding orders from the market to book the trade privately. [237] To participate in private futures transactions, an exchange member would have confronted the prohibition of original section 4b. In 1968, for no perceivable reason, Congress revised the text of that section so that, today, section 4b appears to prohibit bucketing of orders by exchange members only if the affected futures contracts are "on or subject to the rules of any registered entity." [238] This revision, in effect, reopened the issue whether futures contracts designed privately could be marketed through exchange members.

Despite the repeated efforts by Congress to deal with preventing off-exchange futures trading, ambiguities persist. For instance, while section 4b of the Act prohibits exchange members from bucketing a customer's orders, it allows that member to take the other side of the transaction with the customer's consent. In the operation of a typical "bucket shop," the vendor would necessarily have the counterparty's consent and the relevance of section 4b is plunged into doubt. The imprecision of the Act on this issue, however, has left open an unsettled playground for advocates of either view. [239]

Some state legislatures have empowered state securities administrators to deal with commodities fraud. These statutes facilitate enforcement of prohibitions against illegal bucket shops, especially those operated by persons who are not part of an organized contract market. [240] Indeed, section 12(e) of the Act, despite the CFTC's overreaching "exclusive jurisdiction" with respect to futures trading, authorizes the states to adopt laws respecting off-exchange trading as well as persons who fail to register or be designated with the CFTC when required to do so. [241]

The scope of the CFTC's original contract market monopoly was also placed in doubt as a result of court decisions. In interpreting the Treasury Amendment to the Commission's jurisdictional grant, the Fourth Circuit held, in *Salomon Forex, Inc. v. Tauber*, that foreign currency futures contracts are not covered by the Act unless they are executed through a board of trade. [242] It is noteworthy that the court was mindful of the fact that the plaintiff was a professional, sophisticated investor who was not in need of the same protections as public investors generally. Subsequently, however, the Second Circuit rejected the *Tauber* decision on other grounds. [243] The Second Circuit held that the phrase "foreign currency transactions" in the Treasury Amendment did not include options in foreign currencies and thus off-exchange options contracts are within the Commission's subject matter jurisdiction. [244] However, the Supreme Court reversed, holding that off-exchange foreign currency options activity falls outside CFTC's jurisdiction.

Another inroad on the contract market monopoly was the 1995 adoption of an exemption for trading by professional and institutional investors of certain exchange-traded products. Section 5d of the Act as well as Part 36 of the Commission's Regulations exempts these products from registration requirements, risk disclosure rules, trading rules, and reporting requirements for certain transactions by professional and institutional traders in qualified exchange-traded products. The impetus was to permit the exchanges to compete more effectively with trading among professionals and institutions in off-exchange products.

[8] Deterioration of the Exchange Monopoly: Another Wall Crumbles

In both the original edition of this treatise and in the 1989 second edition, the following observation was made about the "monopoly" enjoyed by CFTC-designated contract markets:

> If it could be said in ancient times that all roads lead to Rome, it is equally true today that all lawful trading in domestic futures (and most lawful trading in domestic commodity options) occurs on one of the nation's thirteen active designated contract markets. In domestic futures trading, there is no such thing as a lawful over-the-counter market.… [245]

Within the past several years, however, a combination of actions by Congress, the CFTC, and the courts have made that claim—accurate to a fault when written—seem naive at a minimum. A tenet of commodities regulation that was once believed to be eternal has been replaced by a patchwork of exemptions, exclusions, policy statements, statutory interpretations, and court rulings that, in the best tradition of the law, have birthed so many exceptions to the general rule as to threaten to overwhelm that rule.

These developments contain a certain level of irony. When it is recalled that the nation's boards of trade were brought grudgingly under federal regulation in the 1920s by the promise of having a business monopoly as a result (which Congress obligingly fulfilled), the present specter of continued regulation without this quid pro quo and, indeed, now facing competitors largely immune from pesky regulation, is bitter medicine indeed for the exchanges.

This sea change in the law has other implications as well. The contract market monopoly meant that all futures trading would be isolated on a handful of exchanges that could be monitored with relative ease by the CFTC and its predecessors. Lacking a vast over-the-counter terrain to police, the CFTC has never approached in size the SEC. Moreover, the contained environment in which the CFTC operated made it both more sensible and more workable that its jurisdiction over all futures and commodity options should be exclusive and preemptive. Now that a significant amount of that activity has strayed away, often without a successor regulator, it can be expected that the resulting "gap" will be duly noted and, whether or not justified, sooner or later filled by others.

This section centralizes and analyzes the key information about the deterioration of the exchange monopoly. It first discusses so-called "exotic" derivatives such as swap agreements and hybrid securities that have received special dispensations and exemptions from most regulation as the result of both congressional and CFTC actions. It also notes a change in the CFTC's concept of what constitutes a "forward contract" from the traditional emphasis on the frequency of actual delivery to a starker legal analysis about obligations even where delivery is infrequently observed. This section also discusses the contributions of the courts in interpreting the so-called Treasury Amendment, around since 1974 but for a long time narrowly construed, so that genuine futures contracts and options on some of the industry's most popular financial instruments are now being allowed to be traded, and even offered to the general public, entirely without any CFTC regulation. Finally, the section discusses the decline of exchange dominance after Congress administered a coup de grace called the Commodity Futures Modernization Act of 2000 [246] allowing those markets' largest and most important users to trade identical instruments among themselves, avoiding exchange execution costs, exchange rules or surveillance, and even the CFTC itself.

[A] The New “Exotics”

A quiet revolution began in the middle of the 1980s. While most eyes were on financial and stock index futures, themselves quite new at the time, the university graduate schools were matriculating a breed of financial wizards who were quickly hired by major banks and investment houses to design special financial products that could overlay nearly perfectly with the particular needs of client institutions. Exchange-traded futures and options were often too rigidly structured (necessitated by the fungibility requirement that allowed easy acquisition and liquidation of positions). Perhaps they were too small in size, or had too long a time horizon, or called for delivery or performance at an inconvenient site or, in some cases, there simply did not exist a futures contract or any options related to the client's assets, output, or services.

One of the earliest of these new "exotic" financial instruments was the interest-rate swap, followed soon by foreign currency swaps and, eventually, by equity- or commodity-based swaps. Generally, swaps are designed to hedge or transfer the risk of adverse changes in interest rates, currency conversion rates, or the value of a specified asset. In many instances, banks or investment houses provide "financial intermediation" services by stepping into the middle of swaps where the ultimate owners are third parties not willing to accept the risk of a default by the other party but comfortable that the intermediary's credit stands behind the transaction. Swaps may also be used for purely speculative purposes. One attraction of swaps is that special credit support arrangements can be negotiated between the parties without adherence to the strict margining and mark-to-market rules enforced by the exchanges when dealing in their products, thus potentially freeing up each of the parties' capital for other interim uses.

Developing on a parallel track were varieties of securities, mainly notes or other debt instruments, that repaid principal or generated interest based in whole or in part on the changing value of a selected asset or the occurrence of a specified event. These instruments allowed an investor (or lender) to realize a return that might exceed (but also might fall short of) what could be generated from a standard debt security. Conversely, the potential enjoyed by the investor (lender) to reap exceptional returns meant that the issuer (borrower) could offer the instruments with a lower-than-normal minimum yield, thus saving financing costs. In other instances, these "hybrid" securities made it possible for investors who were subject to investment restrictions, such as conservative pension funds, to make a permissible investment in "securities" but to realize the benefit of favorable changes in the value of an impermissible investment, such as an enhanced principal repayment if the price of gold, crude oil, or another commodity that was not authorized for direct investment were to change in a favorable way. Although beyond the scope of this treatise, the structuring of the instruments as debt might have certain favorable tax consequences as well.

A third category of off-exchange derivative that gained popularity during this period was the over-the-counter (OTC) option on securities or commodities, the latter being broadly defined (as in the Commodity Exchange Act) to include both tangible and intangible assets ranging from grains or metals to stock indexes and other mathematical measurements of price change or other phenomenon. OTC options on securities and securities indexes are regulated by the SEC while all other OTC options are subject to the CFTC's jurisdiction which permits some types of options while banning other types. [247] The attractions of OTC options are comparable to those for swaps, namely, the ability to tailor the terms to very precise needs that exchange-traded options may be too inflexible to provide, and also the freedom to negotiate credit support terms that are different from the rigid margining and daily mark-to-market regimes used by the exchanges.

Swaps were the first off-exchange instrument to attract the CFTC's attention. [248] In 1989, after reviewing swaps and their possible place in the galaxy of regulated derivatives, [249] the CFTC described swaps as "in general… an agreement between two parties to exchange a series of cash flows measured by different interest rates, exchange rates, or prices with payment calculated by reference to a principal base (notional amount)." [250] For example, the parties might agree to exchange funds where one will pay a fixed amount per quarter (*e.g.*, eight percent interest on a hypothetical or "notional" loan) while the other party will pay whatever is the then-existing floating rate in the eurodollar deposit market (LIBOR) on the same notional loan. Or, one party might agree to pay a fixed number of U.S. dollars each quarter in exchange for a specified quantity of a foreign currency. [251] In nearly every case, one party gains from the price fluctuation while the other suffers an equivalent loss. For example, a currency swap where Party A agrees to pay US$100 for a hypothetical 100 Japanese yen at periodic intervals is profitable for Party A as long as 100 yen are worth more than US$100 but is profitable for Party B when US$100 is more than the value of 100 yen. Thus, in the above illustration, Party A would receive from Party B the sum of US$20 if 100 yen were worth US$120 on a given interval payment date, while Party B would receive US$20 from Party A if 100 yen were worth US$80 at that time.

The symmetry of gains and losses on swap transactions bears a striking economic similarity to futures contracts, especially when the substitution of cash payments (parallel to futures offsets) for physical performance is the norm. Physical delivery on swaps is quite uncommon. This caused the CFTC to observe that most swap transactions possess "elements of futures or options contracts." [252] It thus became an issue whether swaps are futures contracts for regulatory purposes, in which case the validity of swaps totaling in the trillions of notional dollars might be questioned as they were not conducted on or subject to the rules of a contract market as required generally for futures contracts by section 4(a) of the Act. [253] And, to the extent that swaps might be tied to changes in the value of a common stock (one form of "equity swaps"), the absolute prohibition in former section 2(a)(1)(B)(v) of the Act (part of the Johnson-Shad Accord) against transactions in stock futures cast a cloud over these transactions further. [254] In that event, not only would swap participants have faced potential charges from the CFTC but, often of equal or greater concern, counterparties might escape the payment of substantial accrued obligations on a *void ab initio* theory. The Commodity Futures Modernization Act of 2000 [255] eliminated this prohibition and security futures products are now permitted. [256]

The CFTC's earliest response to these issues was to circulate for comment and to later adopt a "Policy Statement" on the subject. [257] This action held legal significance in at least two respects. First, the CFTC stopped short of deciding that swaps are not futures contracts, and thus sought to create merely a "safe harbor" for some swaps meeting six (6) discrete tests. Second, there was confusion about the legal effect of a pronouncement styled as a "policy statement." Was it a definitive interpretation of the Act (the CFTC usually characterizes those as "statutory interpretations"), a sort of "no-action" position, or simply akin to an exercise of prosecutorial discretion? Until 1993, this Policy Statement was the swap industry's only legal life raft and, while it assured that CFTC prosecutions would not occur where the litmus tests were met, could the CFTC's internal "policy" bind the courts or inhibit private litigation? Moreover, regardless of any CFTC "policy," what would prevent a state or a loss-making counterparty from asserting that cash-settled swaps are contracts for differences and, therefore, in violation of local gaming laws?

In essence, the CFTC set as standards for permissible swaps a series of characteristics, which tend to differentiate them from futures contracts. First, to qualify for safe harbor treatment, the economic terms of the swap must be subject to individual negotiation between the parties (although standardization of noneconomic terms and even the use of "master agreements" are permissible). In particular, the CFTC required that credit-related matters be negotiated. Second, no mechanism could exist whereby a swap party might unilaterally liquidate or offset its obligations under the agreement. To achieve that end, it would be necessary to procure the consent of one's counter-party, which could be refused. Third, no futures-style system of margining or of a clearing house guarantee could exist. As with the first test, this requirement was intended to distinguish swaps from futures by emphasizing the greater credit risk of the former. Fourth, the parties must enter into the swap in conjunction with their lines of business. The principal objective of this standard was to foreclose participation by the general public having no commercial nexus to the subject matter of the swap itself. A "line of business," however, could include a common practice among investment bankers of acting as financial intermediaries between two opposite swap "end users." Finally, swaps would remain eligible only so long as they were not marketed to the general public.

During that same period, the CFTC and its staff also took an interest in the new hybrid instruments comprised mainly of debt securities whose performance is affected by changes in the value of something else: a commodity, a stock index, an economic indicator, or some other benchmark. Because of the tie-in of performance to the separate benchmark, these hybrid instruments appeared to contain two coupled components: a debt security, and either a futures contract or an option on the benchmarked asset or item. Even though the futures contract or option was said to be imbedded in the security, these instruments nevertheless raised the same issue as swaps: if a CFTC-regulated futures contract or option exists, were the transactions unlawful for having been conducted away from a regulated contract market? And, if the imbedded futures contract involved changes in the price of a common stock, might it be prohibited by the Johnson-Shad Accord's ban on stock futures? Finally, if these instruments involve an off-exchange futures contract, might they be vulnerable to attack under state gaming laws?

In 1989, the CFTC adopted Part 34 regulations seeking to define permissible hybrid instruments that contain an options component. [259] By reason of section 4c(b) of the Act [260] which authorizes the CFTC to grant exemptions in the case of options, the CFTC could (and did) grant a formal exemption from the Act for qualified hybrids. Instruments with an imbedded futures component would need to be handled differently because at that time the CFTC did not have statutory authority to exempt futures contracts from the Act. As for options-based hybrids, the CFTC limited its exemption to debt securities, preferred stock, and certain depository instruments provided that the value of the implied option premium is not greater than 40 percent of the issue price of the instrument, the issuer meets stated qualifications, the instrument is not marketed as a futures contract or option, and settlement does not involve delivery of an instrument used by a contract market. Furthermore, if settlement is to occur with reference to prices reported by a contract market or on its behalf, the issuer must notify the CFTC of the issuance of the hybrid security within five days of the offering date.

For hybrid instruments with futures-style characteristics, the CFTC adopted a "statutory interpretation" in 1989, [261] the effect of which was a declaration by the CFTC that certain hybrid instruments "are not within the coverage of the Act and Commission regulations. [262] In this way, the CFTC took the view that eligible hybrids need not conform with any of the Act's requirements, implicitly including the ban on stock futures in former section 2(a)(1)(B)(v) of the Act. To be eligible, however, the hybrid instruments must not provide for payments that exceed the rate of change in the indexed asset, that is, changes must be on no more than a one-to-one basis. In addition, the investor's maximum potential loss may not exceed the principal and interest otherwise payable on the instrument; that is, the investor may not become obligated to pay any additional consideration. Moreover, a comparison must be made between the terms of the hybrid instrument and the terms of a similar instrument offered conventionally without the indexation feature. It must be determined that the yield on the hybrid instrument is at least 50 percent but not more than 150 percent of the yield on a conventional instrument of similar quality. The futures-like component must remain imbedded in the instrument and cannot be separated for other uses. The hybrid, if settled by means of a delivery instrument, may not use delivery certificates or similar documents that are eligible for delivery on contract markets' futures. Finally, the hybrid could not be marketed as being or having the characteristics of futures or commodity options.

Both of these actions by the CFTC, related to swaps and to hybrid instruments, were generally greeted favorably, especially by swap dealers and end users as well as by issuers and investors for hybrid instruments. Nevertheless, the need to rely on a "policy statement" for swaps and, in part, on a "statutory interpretation" for futures-like hybrids, left open the possibility that a court might reach a different conclusion. As a consequence, the CFTC and interested parties sought and obtained from Congress in 1992 the ability for the CFTC to issue formal orders of exemption that would have binding precedential value in the courts. The Futures Trading Practices Act of 1992 adopted section 4(c)(5)(B) of the Act, which expressly granted the Commission the authority to exempt swap transactions. [263] The 1992 exemptive authority, which as discussed below has its limits, was designed to give certainty in the development of innovative financial products. [264] The Commission has exercised its exemptive authority with regard to a wide variety of transactions between sophisticated parties. [265] In 2000, the Commission proposed additional rules for certain swap transactions that would have the effect of extending the exemption to other commodities products and thus would have truly opened up an over-the-counter market for futures. [266] The power to exempt, however, was delimited in a variety of ways. First, an exemption could only run to certain types of "appropriate persons" defined to assure that the general public could not engage in these activities unless the CFTC otherwise allowed it. Furthermore, while exemptions could be granted from virtually every provision of the Act and of CFTC regulations, no exemption would be permitted from section 2(a)(1)(B) of the Act, the Johnson-Shad Accord, which prohibits futures on individual stocks (and other nonexempt securities) and sets standards for approving stock index futures contracts. In 2000, several proposals were introduced into Congress to repeal the Johnson-Shad accord, at least with regard to the prohibition on futures on individual stocks. [267] There seems to be growing support for repeal, although as of June, 2000, disagreements remained as to how to implement the repeal. [268] In September 2000, the SEC and the CFTC agreed on a proposal to permit trading futures on individual stocks. Under this proposal, futures on individual stocks could be traded on either securities or commodities exchanges, but regardless of where the stock futures were traded, they would be "securities" and thus subject to SEC regulation. [269]

The refusal of Congress to allow the CFTC to exempt any person from section 2(a)(1)(B) 's prohibition against futures on individual securities contrasts sharply with the CFTC's earlier swap policy statement which did not suggest that eligible swaps would remain subject to that provision, and with its statutory interpretation for hybrid instruments which can be construed as placing eligible hybrids entirely beyond the reach of the Act. The CFTC has sought to reconcile this discrepancy by considering its exemptive power acquired in 1992 as an additional tool that supplements rather than replaces its earlier pronouncements in 1989 and 1990. [270]

At the same time that Congress adopted the CFTC's exemptive authority for swap transactions, the Futures Trading Practices Act of 1992 also preempted the application of state bucket shop laws to exempt swap transactions. [271] The legislative history explains that this state law preemption was designed to provide certainty that exempt swap transactions would not be regulated either at the federal or state level, except for the applicability of general antifraud proscriptions. [272] The preemption of state law applies retroactively to exemptions granted [273] prior to the adoption of the 1992 amendments to the Act. [274]

In early 1993, the CFTC formally acted under its new exemptive power to provide exemptive orders for both swaps [275] and hybrid instruments. [276] In the case of swaps, only persons meeting the specified "appropriate persons" standard under the Act could claim the exemption, with minor exceptions. For hybrids, however, the CFTC exercised its right to add to the "appropriate persons" list by stating that anyone could invest in hybrid instruments unless prohibited by other laws from doing so. Thus, while members of the general public remain barred from exempt swaps, they are free to engage in hybrid instrument transactions unless they are subject to legal restrictions to the contrary.

Part 34 of the CFTC's regulations [277] sets the exemptive standards for hybrid instruments and applies equally to futures-style and option-based hybrids. It also applies to any person providing advisory or other services in connection with an exempt hybrid transaction which appears to obviate any need to register under the Act for such activities. The exempting rules are broader than the 1989 options-oriented regulation and the 1990 futures-related statutory interpretation in that they apply to all types of securities as defined in the Securities Act of 1933, as well as to certain depository instruments. A hybrid instrument would be exempted from the Act (except former section 2(a)(1)(B)), so long as the value of the commodity-independent component is greater than the value of the commodity-dependent component, the investor's initial payment represents payment in full, the instrument is not marketed as a futures contract or commodity option, and settlement does not involve any delivery instrument used by a contract market. Thus, the proportion of total instrument value that could be commodity dependent rose from the previous 40 percent to 49.99 percent, and the one-to-one indexing limitation was removed so that eligible hybrid instruments can now be leveraged more acutely. The only provision of the Commodity Exchange Act that continues to apply is section 2(a)(1)(B), the Johnson-Shad Accord.

The CFTC's swap exemption originally appeared in Part 35 of its regulations. However, in 2011, following enactment of the Dodd-Frank Act's comprehensive new regulatory regime for swaps, the CFTC repealed Part 35 and replaced it with a provision exercising its authority under Dodd-Frank to permit agricultural swap transactions. Under this provision, agricultural swaps are made subject to the same rules applicable to all other swaps. [278]

[B] Forward Contracts (Including “Forwards” Without Delivery)

Another development during the same period pertains to the distinction between a "futures contract" and a "forward contract" and has broadened, somewhat, the use of arrangements involving commercial participants that are entered in contemplation of actual delivery but are cash-settled pursuant to a new, separate agreement that is subsequently reached between the parties. Historically, in distinguishing between futures and forwards, the CFTC had tended to place heavy reliance on whether physical delivery actually took place. [301] The CFTC view was that the Act, in section 1a(19) [302] means to exclude from treatment as futures contracts only those arrangements entered into for commercial reasons where performance takes place but may be deferred for a time as a matter of convenience or necessity.

That posture changed when the CFTC was asked to rectify the danger, created by the U.S. District Court for the Southern District of New York in *Transnor (Bermuda) Limited v. BP North America Petroleum*, [303] that transactions in the North Sea ("Brent") crude oil market would be treated as unlawful off-exchange futures contracts because the obligation to make physical delivery of crude oil was often waived by the parties through an understanding reached subsequent to executing the original firm-delivery contract. In *Transnor*, the court estimated that waiver of delivery by the parties to Brent transactions occurs roughly 95 percent of the time, a dramatic contrast with the CFTC's previous characterization of forwards as agreements where "delivery, in fact, routinely occurs."

In 1990, the CFTC issued a "Statutory Interpretation Concerning Forward Transactions" [304] expressing the view that transactions entered into between commercial parties in normal commercial channels should not be considered as futures contracts where binding delivery rights and obligations arise from the original contract but where, in a separate and subsequent new agreement, which either party is free to decline, settlement in cash in lieu of physical delivery is substituted. This pronouncement was based upon the CFTC's understanding of the Brent crude oil market and its practices and, as noted below, its applicability to forward contracts generally (though styled to suggest broad applicability) has not been widely tested. However, the CFTC's formulation was subsequently embraced by the U.S. Court of Appeals for the Ninth Circuit in *Krommenhoek v. A-Mark Precious Metals, Inc.*, [305] an action involving gold and silver bullion rather than energy products.

The Fourth Circuit set out four factors to consider in identifying a forward contract. [305.1] A forward contract generally includes the following four characteristics: (1) the primary subject of the contract is the commodity itself as opposed to packaging, marketing, shipping or other costs; (2) the contract requires payment at a fixed price with delivery more than two days after the agreement; (3) the quantity term and timing for delivery are fixed in the agreement when made; and (4) there is no requirement for the contract to be traded on an exchange or otherwise in the financial markets. [305.2]

First, the subject of a commodity forward agreement must be a commodity. That is, substantially all of the expected costs of performance must be attributable to the expected costs of the underlying commodity, determined at the time of contracting. This element, which is inherent in the word "commodity," distinguishes a commodity forward agreement, in which the benefits or detriments depend on future fluctuations in commodity prices, from many supply contracts, in which costs attributable to other factors, such as packaging, marketing, transportation, service, and similar matters contribute to a greater portion of the costs.

Second, a forward commodity contract, in being "forward," must require a payment for the commodity at a price fixed at the time of contracting for delivery more than two days after the date the contract is entered into. [305.3] A maturity date in the future means that the benefit or detriment from the contract depends on future fluctuations in the market price of the commodity.

Third, as a forward agreement in relation to a commodity, in addition to the price element, the quantity and time elements must be fixed at the time of contracting. [305.4] Where the *Wall Street Journal* has used the term "forward agreement" and provided details of the transaction, it has always described fixed quantities and prices: "35 million shares," "$250,000 of marks," and "$1 million of bonds." [305.5] These requirements are confirmed by the common meaning given to a "forward contract" as "a privately negotiated investment contract in which a buyer commits to purchase something (as a quantity of a commodity, security, or currency) at a predetermined price on a set future date." [305.6]

Finally, while the broad class of "swap agreements" includes contracts that are readily assignable and therefore tradable, "swap agreements" also include forward contracts, which are not necessarily assignable. The Chicago Mercantile Exchange's online glossary's definition states that "[i]n contrast to *futures* contracts, *forward* contracts are not standardized and not transferable." [305.7]

As with the CFTC's statutory interpretation for hybrid instruments, the business community was less than satisfied by the agency's use of a similar vehicle in the case of Brent forward contracts. A court would not necessarily be bound to adopt the CFTC view. But, as noted earlier, the CFTC did not have statutory exemptive powers for futures contracts at the time which would be enforceable in court. Therefore, immediately after adoption of the 1992 amendments to the Act, which in new section 4(c) [306] awarded the CFTC formal exemptive power, the agency began a process which led to the entry of an Order exempting Brent-type transactions from treatment as futures contracts. [307] While the variety of products embraced by the Order went beyond Brent crude oil, it was nevertheless confined to specified energy products, and despite urgings by commentators the CFTC refused to give it broader application. As with the exercise of exemptive power for swaps and hybrid instruments, however, the agency made clear that the statutory interpretation remained effective as well. But unlike the exemption for swaps, the Act's antifraud and antimanipulation provisions were not preserved.

While the exemptive order for energy products has provided added clarity to forward contracting where the incidence of delivery may be low, it has not deterred the CFTC from examining with a critical eye the economic reality of energy transactions, as witnessed by the CFTC's complaint and settlement in *In the Matter of MG Refining and Marketing, Inc. et al.* [308] There, MGR&M offered to customers (independent gasoline stations and heating oil distributors) long-term supply contracts in gasoline, heating oil, and diesel fuel. Deliveries did not occur unless and until a customer requested the product on 45-days' advance notice to MGR&M, and each contract contained a "blow-out" provision allowing the customer to terminate the contract and to receive a cash payment from MGR&M if the price of the energy product futures contract on the New York Mercantile Exchange reached a specified level.

The CFTC exemptive order for energy transactions did not prevent the Commission from exerting jurisdiction over market manipulation involving natural gas prices. Thus, for example, even though forward contracts related to natural gas, the defendant's false reporting of prices fell within the Act's and the Commission's purview. [308.1] The Commission's jurisdiction was upheld even though the transactions involved were cash transactions rather than futures contracts. [308.2]

This practice came to the CFTC's attention after MGR&M and its parent, the German industrial giant Metallgesellschaft A.G., announced that the program had generated in excess of $1 billion in losses and that a rescue by bank shareholders was being arranged. Looking to the economic reality of the transactions, the CFTC concluded:

> Virtually all purchasers entered the 45 Day Agreements with the intent of invoking the "blow-out" provision for the purpose of speculating on the price of the underlying product. This speculative intent was encouraged by MGR&M sales presentations which emphasized the likelihood that prices would reach the exit level well before the expiration of the contract term and, if they did not, alternative arrangements could be made to offset the contracts without delivery. * * * In fact, no deliveries of product were made pursuant to the 45 Day Agreements. [309]

Accordingly, the CFTC found that MGR&M had engaged in unlawful off-exchange futures contracts with its customers contrary to section 4(a) of the Act, as well as supervisory and financial reporting violations. This case underscores that, notwithstanding the CFTC's prior relief in the energy area, each program will be examined to determine whether it qualifies for that relief or, even as between commercial users, is speculative in purpose and expected to result in cash settlement.

Another area of controversy has arisen with regard to hedge-to-arrive contracts used principally in the farm products sector. [310] A hedge-to-arrive contract is a contract for actual delivery at a later date. [311] The contract may or may not specify the exact time for delivery. If actual delivery is in fact contemplated, a hedge-to-arrive contract (HTA) is properly characterized as a forward contract not subject to the Commodity Exchange Act. [312] Whether a hedge-to-arrive contract is a regulated futures contract or an excluded forward contract generally depends upon a factual inquiry. [313] The key factual issue is the actual investors' expectations. [314] The majority of decisions have found that most parties to hedge-to-arrive contracts contemplate delivery and thus those HTAs are forward contracts rather than futures contracts. [315] Hedge-to-arrive contracts sometimes have roll over provisions, where the investor can roll over into a later contract and avoid delivery under the original contract. The presence of limited rollover provisions will not in itself demonstrate that delivery is not contemplated. [316]

The CFTC has indicated that anything beyond limited roll over provisions will render a hedge-to-arrive contract a futures contract rather than a forward contract. [317] The Commission warned that anything beyond sequential rolling out to a different price in the same year could jeopardize the exclusion for forward contracts. [318]

As noted earlier, determination of whether an HTA contract is a futures or a forward contract is a factual determination based on the terms of the contract and the nature of the participants in the transaction. [319] There is an ever-increasing number of court decisions finding that HTAs were unregulated forward contracts rather than illegal off-exchange futures contracts. [320] The Commission has nevertheless maintained an aggressive stance with regard to contracts that it believes do not fall within the forward contract exclusion. [321] At least one court has indicated that it need not defer to the Commission's position as to whether a particular HTA contract is a forward or a futures contract. [322] Notwithstanding the weight of the cases finding HTA transactions to be forward contracts, courts have on occasion found HTA contracts to be futures contracts. [323] The known inability of a customer in an HTA transaction to take delivery will weigh heavily in the determination that a futures contract exists. [324] In contrast, the presence of a flex HTA contract wherein there is the discretion to defer delivery will not require a determination that a futures contract exists. [325] Independent of whether hedge-to-arrive contracts are futures contracts is the question of their enforceability under state contract law. For example, the Nebraska Supreme Court upheld the validity of HTA contracts notwithstanding the claim that they were illusory and therefore unenforceable. [326] That same court also found that the contracts were forward rather than futures contracts and thus were not subject to regulation under the Commodity Exchange Act. [327]

In *Nagel v. ADM Investor Services, Inc.*, [328] the Seventh Circuit canvassed the case law and concluded that a contract will be deemed a forward contract as long as all of the following circumstances are present:

(1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is not fungible with other contracts for the sale of the commodity, as securities are fungible. But there is an exception for the case in which the seller of the contract promises to sell another contract against which the buyer can offset the first contract.…That promise could create a futures contract.

(2) The contract is between industry participants, such as farmers and grain merchants, rather than arbitrageurs and other speculators who are interested in transacting in contracts rather than in the actual commodities.

(3) Delivery cannot be deferred forever, because the contract requires the farmer to pay an additional charge every time he rolls the hedge. [329]

Judge Posner, speaking for the court, described this as a restatement of the "totality of the circumstances" approach. [330] He also eloquently pointed out that the test as refined is designed to prevent plaintiffs from bringing frivolous suits but at the same time prevent clever drafting of contracts simply to evade the Act's coverage. [331] In the more recent *Zelener* decision, [331.1] Judge Easterbrook questioned the use of the three-part totality of the circumstances test. [331.2] Instead, he applied a literalist approach, focusing on the language of the statute and the "technical" rather than lay meaning of the terms "forward contract" and "futures contract." [331.3] Judge Easterbrook also made analogy to the cases determining whether a security exists under the federal securities laws and the importance of looking at the economic reality based on the terms of the contract in question. [331.4]Other courts have pointed out that the CFTC is not entitled to deference in its determination of whether an investment is a futures contract subject to CFTC jurisdiction or a forward contract that is not. [331.5]

In *CFTC v. White Pine Trust Corp.*, [331.6] the Ninth Circuit explored the scope of the Commission's jurisdiction over forex options and forex option discretionary trading accounts. Section 2(c)(2)(B)(i) of the Act gives the Commission jurisdiction over foreign currency options. [331.7] However, although there may have been a contrary congressional intent, Congress did not draft the statute to cover discretionary accounts for forex options. [331.8]

Accordingly, the Commission did not have jurisdiction over alleged fraud in opening the account in the absence of fraud in particular option transactions. [331.9]

[C] OTC Securities Options

Although not "new" in the past few years, [332] over-the-counter securities options have witnessed a growing level of popularity. Unlike activity governed by the Commodity Exchange Act, securities options are subject to the federal securities laws [333] and to regulation by the SEC, [334] a jurisdictional assignment that was effected in the Johnson-Shad Accord of 1981. [335] And unlike traditional futures regulation, neither Congress nor the SEC has confined trading in securities options to the organized exchanges. As a result, investors and their brokers have far greater flexibility in designing, offering, and trading securities options for particular purposes. Securities options offered over-the-counter are often referred to as "conventional" options.

Of course, many securities options are also available on organized exchanges such as the Chicago Board Options Exchange, organized in 1973 as the nation's first central market for "standardized" securities options. [336] Like futures contracts, most terms of "CBOE-style" securities options have been made uniform. The same is true of exchange-traded "warrants" (generally securities options having a duration longer than most CBOE-style options), which generally originate with a private issuer but are then listed on an exchange. This uniformity, coupled with the substitution of a clearing house as counterparty on each trade (in the case of OBOE-style options but not listed warrants), facilitates the ability of investors to offset their positions in the market.

But uniformity can also be a constraint where investors or hedgers desire securities options with features not available on the exchanges. Neither CBOE-type options nor listed warrants offer the versatility of customized OTC securities options, although some exchanges have introduced so-called "flex" options that allow the parties to choose from a menu of variable terms. On the other hand, while OTC securities options allow maximum flexibility, they may be more difficult to value and to liquidate precisely because their customization impedes the development of an active market for them, and the absence of a clearing house raises credit risk to a higher level than for CBOE-style options.

While exchange-traded securities options are subject to pervasive SEC regulation, [337] including presentation to investors of a generic Options Disclosure Document about those instruments, OTC securities options are significantly less regulated. While they are generally subject to all of the requirements and restrictions applicable to "securities" (they being defined as such by law), including prohibitions against fraud, insider trading and the like, OTC securities option transactions are otherwise not singled out for special regulatory treatment. A possible exception is that position limits established under rules of the National Association of Securities Dealers, Inc. for exchange-listed securities options cover OTC securities options as well (except options on securities indices) so that broker dealers must aggregate each client's exchange-traded and OTC options in calculating position levels. The NASD has also promulgated other OTC requirements. [338]

Not all OTC securities options are publicly traded. OTC securities options are often offered on a private placement basis, [339] which obviates the need to register the options with the SEC. They may be offered by persons other than the issuer of the underlying security, and the issuer cannot block third-party offerings of options on its securities as a general rule. [340] Securities options may be offered as a free-standing investment or, as noted earlier, may be "imbedded" in other instruments (popularly known as "hybrids"). When offered by the issuer of the underlying security, the motivation may be to earn premium income (perhaps backed by treasury stock), to facilitate a stock buy-back program (e.g., offering put options on the company's stock), or to hedge against a down-turn in the value of held securities. For other issuers of securities options, the motivation may be to earn premiums or fees, to lower borrowing costs on debt by imbedding an attractive option, or simply to accommodate a valued client. [341]

The SEC has implemented a registration requirement for dealers in over-the-counter derivative securities. [342] This new registration requirement is a streamlined version of the SEC's registration requirements for broker-dealers generally. This "broker lite" registration for OTC derivatives dealers was opposed by the CFTC. [343] The OTC derivative registration requirement applies to firms that otherwise would not be subject to the SEC's regulation. The streamlined process permits registered derivatives dealers to issue and reacquire "eligible OTC derivative instruments" as that term is defined by SEC Rule 3b-13.2. [344] In addition to the derivatives transactions, registered derivatives dealers may engage in cash management securities activities [345] and "ancillary portfolio management securities activities." [346] The SEC registration leaves the following situation: The SEC will regulate OTC derivatives if they are securities but not if they truly are commodity products. The SEC will regulate OTC derivatives if they are securities but not if they are not securities. [347]

In a reversal of prior law, the Commodity Futures Modernization Act of 2000 (CFMA) [348] permits the trading of futures contracts on single stocks and narrow-based security indexes. [349] The Shad-Johnson Accord's ban on most equity-based futures contracts has been lifted. Security futures products may be traded on either securities or commodities exchanges. The CFMA, in establishing this co-regulatory system, directs the SEC and CFTC to coordinate their regulatory oversight over security futures products. The CFTC and the SEC adopted joint rules establishing customer margin requirements for security futures products. Among other things, these rules set minimum initial margin requirements and maintenance for unhedged positions in security futures at 20 percent of their current market value. [350] In addition, the Act currently imposes other restrictions such as a requirement that an index on debt securities may not be traded (the 1980 Shad-Johnson accord contained no such restriction). On the other hand, stock index futures contracts that are not deemed to be "narrow-based" under the standards set forth in section 1a(25) of the Act [351] no longer need concurrence from the SEC in order to trade. [352]

[D] The Ascendancy of the Treasury Amendment

While the CFTC's jurisdictional stretch was being reconsidered and somewhat redefined by the actions taken by both Congress and the agency, the courts were rendering decisions that have further impacted what the CFTC regulates. After some years of little notice, litigants have aggressively asserted that the Act and CFTC regulations do not apply to certain types of activity, in futures and options as well as other instruments, by reason of former section 2(a)(1)(A)(ii) of the Act, known popularly as the "Treasury Amendment." [353] This provision, adopted by Congress in 1974 to accommodate a Department of the Treasury concern that the new CFTC's jurisdiction could be construed so broadly as to regulate traditional areas of trading among banks and dealers, stated that:

> Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade.

For many years, and, indeed, as reflected in this treatise, [354] it was the widely held view that the Treasury Amendment, despite its linguistic sweep, was nothing more than a "carve-out" to protect from CFTC regulation the traditional trading areas of banks and financial institutions such as the interbank foreign currency market.

One of the earliest defensive uses of the original Treasury Amendment came in 1986 when the defendants in *CFTC v. The American Board of Trade* [355] urged the U.S. Court of Appeals for the Second Circuit to absolve them from liability under the Act on the grounds that their promotion of options on foreign currency to the public involved "transactions in foreign currency" under the Treasury Amendment. The court focused on whether the defendant's options "on" foreign currency were equivalent to transactions "in" foreign currency and concluded that they were not, at least until such time as they were exercised into the currency itself. The court found it unnecessary to address whether the activity was conducted on a "board of trade," another prerequisite to CFTC jurisdiction under the original Treasury Amendment. The Second Circuit used the same reasoning in *CFTC v. Dunn* [356] but was subsequently reversed by the Supreme Court, which held that options on foreign currency were covered by the Treasury Amendment exclusion from CFTC jurisdiction. [357]

The "board of trade" issue would not be avoided for long, however. In *Salomon Forex, Inc. v. Tauber*, [358] options as well as futures contracts on foreign currency had been entered into between the parties on a private, off-exchange basis arguably in violation of section 4(a) of the Act. The defendant sought to avoid paying his multimillion dollar losses on the transactions by claiming that Salomon had sold him unlawful futures and options. Adopting a strict constructionist approach to the Treasury Amendment, the U.S. Court of Appeals for the Fourth Circuit rejected the arguments that futures and options were not intended to be covered by the Treasury Amendment or that only interbank activity was intended to be protected from CFTC regulation. Rather, it concluded that all types of transactions involving the designated instruments are covered by the Treasury Amendment and that, as for whether only banks and other institutions may benefit from that safe harbor, "it is the nature of the trade (whether a standardized trade within an organized market or an individually negotiated private deal), not the corporate form of the trader, that determines whether a trade is within the Act." [359] As for whether a "board of trade" was involved, the court cited the agreement of both parties that the transactions were off-exchange activity but left open the possibility that a board of trade might be found to exist where no formal exchange exists but where a mechanism is created by a private entity to facilitate public participation in such activity. However, at the same time, the Fourth Circuit stated that "we would be inclined to reject" the idea that a private company like Salomon Forex might be a "board of trade." [360]

The notion that a private business organization might be a "board of trade" received its strongest articulation in *CFTC v. Standard Forex, Inc.*, [361] where the U.S. District Court for the Eastern District of New York suggested that the phrase "formally organized futures exchange" used in Congress' description of a board of trade for Treasury Amendment purposes is intended to refer to "situations in which people create a formal structure for unsophisticated investors who need the assistance of such a formal organization in order to carry out their trading" [362] and implicitly found that a private company offering such "assistance" (such as Standard Forex) could qualify as an "exchange" or "board of trade" within the meaning of the Treasury Amendment and thus might not be entitled to its protection.

Standard Forex suffered orphan status in this regard. Subsequently, the U.S. District Court for the Northern District of California in *CFTC v. Frankwell Bullion Ltd.* [363] was urged to adopt the broad view of a "board of trade" as including private businesses and, after preliminarily signaling that it was "unpersuaded" by the argument, later entered summary judgment in favor of the defendants on that issue:

> If the CFTC's broad interpretation of "board of trade" were to prevail, i.e., that any organization engaged in selling foreign currency futures was a "board of trade," this would render the Amendment meaningless: Every organization would fall outside the scope of the Amendment.

The Ninth Circuit Court of Appeals agreed that the "board of trade" language in the Treasury Amendment did not extend to such privately-vended transactions. [364] Subsequently, in 1997, the Supreme Court ruled that the denial of CFTC jurisdiction over "transactions in foreign currency" includes options transactions. [365] The Court reasoned that the congressional purpose was to provide a broad exemption from CFTC regulation for off-exchange transactions in foreign currency transactions and that a narrow view of the exemption would be contrary to that clear purpose. [366] However, in a subsequent reparations proceeding involving off-exchange leverage foreign currency contracts, a judgment officer held that the Treasury Amendment exclusion did not apply since the contracts were traded publicly among unsophisticated investors. [367] It was reasoned that in light of the long history of differing interpretations of the Treasury Amendment, the Supreme Court's decision in *Dunn* did not affect the Commission's interpretation regarding off-exchange contracts that bear the publicly traded characteristics of foreign currency contracts that should be subject to the contract market requirement. Also, a federal district court has held that the *Dunn* decision involved foreign currency options and thus did not preclude a finding that off-exchange foreign currency futures violate the Commodity Exchange Act. [368] As discussed below, the debate in the courts over the proper scope of the Treasury Amendment's exclusion of foreign currency dealing from the Act led Congress in year 2000 to revise the provision, confirming the CFTC's jurisdiction over activity involving the general or "retail" public. One court took the position that "board of trade" with regard to the Treasury amendment's granting of CFTC jurisdiction only for foreign currency transactions not on a board of trade is limited to transactions on a formal exchange. [369] However, other courts have disagreed, taking a broader definition of the term. Thus, it has been held that a finding that the foreign currency transactions took place on "board of trade" even though not on a formal exchange, will subject the contracts to the Commodity Exchange Act. [370] In 1999, the Commission adopted this view in fording a de facto board of trade in the absence of a formal exchange and thus ruled that the foreign currency transactions were subject to CFTC jurisdiction. [371]

In *CFTC v. Baragosh*, [372] the Fourth Circuit endorsed the Commission's view and rejected the Ninth Circuit's conclusion in *Frankwell Bullion Ltd.*, finding instead that the Treasury Amendment was designed to provide a general exemption for sophisticated off-exchange foreign currency trading. The court held that transactions in foreign currency are not subject to CFTC jurisdiction if they are large-scale, customized, negotiated, bilateral transactions between sophisticated financial professionals. However, they are subject to its jurisdiction if they are small, standardized, offered as-is, and mass-marketed to individuals.

It is important to note that, as the original Treasury Amendment gained prominence as a defensive strategy in cases involving off-exchange transactions in the specified instruments, and attempts to narrow its sweeping language largely failed, significant business opportunities arose as well as competitive advantages. While the cases generally involved foreign currency trading conducted as off-exchange activity all along, an interpretation that futures and options trading in some other instruments, most notably government securities, could also be conducted "upstairs" free from CFTC jurisdiction, threatened to decimate on-exchange trading in some of the world's most popular futures contracts. [373]

In 1999, the President's Group on Financial Markets, of which the CFTC was a member, issued a report critical of the courts' expansive interpretation of the original Treasury Amendment and recommending that the CFTC should have clear authority over retail transactions between parties, neither of which is subject to regulation by any other financial or banking agencies. In addition, the report urged that the phrase "board of trade" in the original Treasury Amendment, which had been construed by some courts as reaching private vendors under circumstances discussed earlier, be replaced by the narrower term "organized exchange." [374] These changes were effected in the Commodity Futures Modernization Act of 2000. [375] However, it was also made clear that the Act does *not* apply to transactions conducted privately between "eligible contract participants" (as defined in section 1a(12) of the Act [376]—ECPs) in foreign currency, government securities, security warrants, security rights, resales of installment loan contracts, repurchase transactions in an excluded commodity (as defined in section 1a(13) of the Act [377]), mortgages, or mortgage repurchase commitments. This outcome, which maintains the risk described earlier that large market users could abandon the organized exchanges and trade some of those markets' most important futures and options privately among themselves, would have happened anyway because other amendments to the Act expressly granted the same rights to ECPs. [378]

[E] A Wrap-Up

The dramatic erosion of the contract market monopoly that began near the end of the twentieth century, not surprisingly, has brought about many new uncertainties as well as opportunities. The expansion of off-exchange trading continues to expand in a piecemeal fashion. For example, in 1995, the Commission exercised its authority under section 4(c) to exempt off-exchange trading by professional and institutional investors of certain exchange-listed products. [379] The driving force behind this exemption was to permit the exchanges to compete more effectively with off-exchange products. But nothing to date has undermined the contract market monopoly more deeply than the Commodity Futures Modernization Act of 2000, [380] which broadly allows off-exchange futures and options trading, even in instruments identical to what is on offer by contract markets, among a generous list of "eligible contract participants" [381] without regard to exchange self-regulatory rules, CFTC regulations, or the execution costs (including deposit of margins) associated with doing business on an organized market.

Notwithstanding the CFMA, organized derivatives exchanges remain an important part of the global market. Thus, for example, worldwide derivatives exchanges experienced an above-average increase in trading activity in the first two months of 2006. [381.1]

Being freed from regulation by the CFTC, whether through statutory exclusion or regulatory exemption, can sometimes cost the liberated person dearly in other ways. A statutory exclusion, or an exemption under either Part 34 or Part 35 of the CFTC's regulations, removes the protection of the CFTC's exclusive regulatory jurisdiction and empowers any other aspiring regulator at all levels of government to enter the picture. While the Act's exclusions and exemptions as well as Part 34 and Part 35 forbid invoking state gaming or bucket shop laws, federal preemption is otherwise wholly lost and, as in the pre-CFTC days, the parties to any affected transaction could be made subject to the requirements of any other federal, state, or local regulatory authority. For example, hybrid instruments involving insurance that qualify for Part 34 exemption can be brought within the grasp of state insurance laws and regulations. On the other hand, not all CFTC exemptions appear to have this effect. For example, the "trade option" exemption under Regulation §32.4(a) does not purport to destroy the CFTC's exclusive jurisdiction over that activity although this exemption waives a general prohibition contained in one of the CFTC's own regulations against off-exchange trading in options. [382]

In 2006, there was some support in the Congress to put the CFTC in direct regulatory charge of the physical energy markets, citing, among other things, Enron, the California energy crisis, and recent litigation. The CFTC already has antimanipulation jurisdiction but the advocates want a more hands-on role, such as collecting volume reports on a regular basis. The CFTC is in the odd position of being opposed, even as it concedes that the futures and physical markets are interdependent.

[F] The Commodity Futures Modernization Act of 2000

On December 21, 2000, President Bill Clinton signed into law the most dramatic changes in futures market regulation since that phenomenon began 78 years earlier. The Commodity Futures Modernization Act of 2000 (CFMA) [383] tore down the barriers to trading that resulted from the contract market monopoly that had been so firmly embedded in commodities law. [384] It codified derivative regulation and clarified the respective roles of the CFTC and the SEC. The new Act also eliminated the prohibition on stock futures on single stocks and narrow-based stock indexes.

The sweeping overhaul of commodities markets regulation brought about by the CFMA has resulted in a three-tiered layer of regulation for those markets. The highest degree of regulation remains with the designated contract markets where retail futures trading takes place.

In order to define those futures and options contracts that are eligible for less regulated or unregulated trading, the CFMA essentially divides commodities into three categories. The first category is commodities that qualify for "excluded" transactions. Those commodities are interest rates, exchange rates, currencies, securities, securities indexes, credit risks, and measures such as inflation and other indexes based solely on commodities that have no cash market or on prices or values not within the control of any party to the transaction. The second category created by the CFMA is commodities that qualify for "exempt" transactions. These are all commodities that are neither "excluded commodities" nor agricultural commodities. For example, this would include contracts based on metals, energy products, and bandwidth instruments. The third category consists of transactions involving agricultural commodities.

The CFMA introduced a new category of futures markets for certain commodities-based products. This new category of market is not open to retail investors generally (unless participating through a registered, highly capitalized, futures commission merchant with clearing privileges on at least one derivative clearing organization) but rather only to specified qualified investors or other investors who trade through a futures commission merchant. [385] This new market was created by the CFMA's new category known as a derivatives transaction execution facility (DTEF). DTEFs are subject to fewer regulatory requirements than CFTC designated contract markets. [386]

The CFMA also created a new market called an "exempt board of trade." [387] Even more restrictive than DTEF eligibility, an exempt board of trade must be confined not only to ECP users but must limit their offerings only to commodities (very broadly defined in section 1a(4) of the Act [388]) that have nearly inexhaustible delivery supply, or are "highly unlikely" to be susceptible to the threat or manipulation, or have no cash market. [389]

The CFMA abolishes the unitary concept of a recognized exchange and the contract market monopoly that formerly existed. Instead, the CFMA recognizes three major types of exchanges for the trading of commodity futures and options contracts: contract markets; derivatives transaction execution facilities; and exempt boards of trade. Special provisions also govern certain electronic trading facilities.

Finally, a dramatic change was made by the Commodity Futures Modernization Act of 2000 to the structure of the clearing organizations that process and guarantee transactions. Previously, the Act gave the CFTC no explicit authority to regulate clearing organizations directly. The agency achieved that result through its ability to make demands on the regulated exchanges that used (and often controlled) the clearing organizations. The Act was amended in year 2000 to create a new and separate CFTC registration process for "derivatives clearing organizations" (DCOs). [390] In this way, the CFTC gained direct access to the DCOs for vetting and supervisory purposes. At least as important, DCOs can now operate independently from any particular exchange, are permitted to clear multiple exchanges, and may clear over-the-counter derivatives as well. From their origins as largely captive "utilities" under exchange control, this development created meaningful competition between clearing organizations for the first time and opened vast new business opportunities to them.

[9] Equity-Based Futures Contracts—Security Futures Products

[A] Overview of Security Futures Products

The CFMA created a regulatory milestone by lifting the former prohibition on equity-based futures contracts, the securities industry and the futures community are determined to harmonize their practices in a way that eliminates any unfair advantages. [391] For example, the initial margin requirement for stock options [392] tends to exceed that for futures contracts. Additionally, the tax rate on stock option profits is higher, too. The SEC charges its " Section 31 " transaction fee [393] on stock options, while nothing similar occurs in the futures markets. Clearly, adjustments are called for now that both stock exchanges and futures markets are allowed to offer the same equity-based futures contracts.

From the perspective of a pragmatic businessperson, the desired outcomes seem obvious. Reduced stock option margins would lower the cost of entry for investors and should attract more trading volume. Similarly, lowering the federal tax rate on options winnings would reduce the cost of exits as well. And, who needs the SEC fee? Certainly not the SEC that sends barge loads of it back to the general Treasury each year! So, why not deliver these benefits to stock option participants? Instead, every "harmonizing" decision was anti-investor!

Futures margins were raised instead. The tax rate on equity-based futures profits was also raised. Moreover, the SEC fee was both preserved and inflicted for the first time on traders using equity-based futures. Finally, exchanges wishing to list securities futures must be prepared to create or to adapt their clearing systems to allow cross-trading (offset) between transactions occurring on the stock markets and on the futures exchanges.

Each of these steps, designed to harmonize regulation among competing exchanges in securities futures, will increase the costs to futures investors of participating in exchange-traded versions of these products. When the additional burdens on the exchanges of financing a revised clearing system, as well as compliance expenses associated with two regulatory authorities are factored in, it is expected that very close attention will be paid by major users to invoking the various bilateral approaches, to which none of these disincentives applies. There is a genuine possibility that the months of legislative toil expended to craft a system of continuous co-regulation by the CFTC and SEC of securities futures, the first concession of its kind by the CFTC in its history, will have been for naught.

Whatever good or bad "deal" has been struck among the nation's stock and futures markets, let us not forget that major institutions and wealthy individuals are free to trade equity-based futures among themselves without any of that baggage. Even diehard futures traders on the traditional exchanges will probably elect to trade almost any contract except equity-based futures as long as comparable volatility exists because none of these disincentives exists outside the equity arena. Have we succeeded in making equity based futures dead-on-arrival? Only time will tell.

It is noteworthy that equity-based futures traded abroad have not been terribly successful. The statistics compiled by the Futures Industry Association show that most foreign exchanges have chosen to trade equity options rather than equity futures. [394] Other Futures Industry Association data reveal that equity options devour the bulk of trading volume even on exchanges where a competing equity futures contract is offered. Taking past experience into account, as well as the formidable presence of the CBOE today, the futures markers need to minimize—not maximize—off-putting contract features like those agreed to in the CFMA.

As this treatise went to press, no U.S. securities or futures market has listed single stock futures or narrow-based stock index futures on its own exchange, but two new joint ventures using electronic trading platforms [395] have been formed by the exchanges for this purpose. Trading is active on both of these platforms.

The securities laws have a special category of securities-based swap agreements. Securities-based swap agreements are excluded from the definition of security under the securities laws, [395.1] but the securities antifraud provisions were extended to apply to securities-based swap agreements. [395.2]

[B] What Is a Security Futures Contract?

The CFMA's definition of a security based futures product (SFP) includes contracts on individual equity securities. The CFMA also includes narrowly based stock index futures. [396] Although imposing different consequences, the CFMA carries forward the previous distinction between broadly based index futures that trade generally under CFTC jurisdiction and narrowly based futures contracts that previously were forbidden but now can be traded as equity based futures contracts. [396.1] A new section of the Act, [397] which is paralleled by a new provision in the Securities Exchange Act of 1934, [398] sets forth the definition of a "security future" [399] contract and "security futures product. [399.1]"

A narrow-based security index is treated as a security future and thus subject to co-regulation by the SEC and CFTC. Section 1a(25) of the Commodity Exchange Act [400] defines a "narrow based security index" as an index meeting *any* of the following criteria: (a) if there are fewer than ten underlying securities, (b) if any underlying security comprises more than 30 percent of the index's weighting, (c) the five most heavily weighted underlying securities comprise more than 60 percent of the index, or (d) the underlying securities with the lowest 25 percent of the index's weighting have an aggregate daily trading volume of less than $50 million on a daily basis or $30 million on a daily basis if the index is comprised of fifteen or more securities. [401] In addition, there is statutory safe harbor from the definition of a narrow-based index: if an index meets *all* of the following tests, it will qualify as a broad-based index. The safe harbor is met if (a) the index has nine or more underlying securities, (b) no security represents more than 30 percent of the index's weighting, and (c) each security (i) is registered under section 12 of the Securities Exchange Act of 1934, [402] (ii) is one of the 750 securities with the largest market capitalization, and (iii) is one of the 675 securities with the largest dollar value based on average daily trading volume.

While the CFMA retains the concept of a "narrow-based" stock index futures contract (co-regulated by the CFTC and the SEC) and a "broad-based" [403] stock index futures contract, the methods used to categorize them have changed radically. Prior to the CFMA, the CFTC's analysis focused on an index's susceptibility to being manipulated or to being used for manipulating any of the underlying stocks. The SEC, which under the former regime could veto any such proposal, preferred to use mathematical benchmarks that eliminate subjective judgment but, at the same time, may be poor proxies when attempting to identify genuine investor risks. The CFMA embraced the SEC approach.

[C] Trading Security Futures Products

As discussed above, in a reversal of prior law, the CFMA amended the Act to permit the trading of futures contracts on single stocks and narrow-based security indexes. Security futures products may be traded on either securities or commodities exchanges. The CFMA in establishing this co-regulatory system directs the SEC and CFTC to coordinate their regulatory oversight over security futures products. A securities future is defined as a security, which makes the Securities Exchange Act of 1934 generally applicable to trading of security futures products. [404] Securities futures can be traded only on common stock registered under Section 12 of the Securities Exchange Act of 1934. [405] Those securities are subject to the detailed SEC periodic reporting requirements. [406]

As noted above, the CFMA permits trading of securities futures either on a national securities exchange registered with the SEC, [407] or a contract market or DTEF that is registered with the CFTC. [408] A contract market that trades security futures must be cross-registered with the SEC. Conversely, a securities exchange that trades securities futures has its primary regulation by the SEC but must be cross-registered with the CFTC.

Additional regulations are imposed as a prerequisite to trading in securities futures. For example, suitability requirements are imposed on a contract market or DTEF trading security futures products. [409] The suitability requirements for securities futures traded on a contract market must be comparable to the suitability requirements imposed by a national securities association. [410] Traditionally, the CFTC has declined to adopt suitability rules [411] because, while small investors are entitled to trade in futures markets, the vast majority of trading volume is generally attributed to commercial and financial institutions, collective investment vehicles, or high-net-worth individuals. It has also been understood that, because the brokerage firms (futures commission merchants) handling customer accounts are liable for market losses not paid by their customers, screening procedures at that level are effective without the formality of a suitability standard.

The cross registration provisions for contract markets and securities exchanges that trade securities futures is an example of the "passport" concept introduced by the CFMA. The passport concept is also applied to futures commission merchants and securities broker-dealers, investment advisers [412] and commodity trading advisers and to investment companies and commodity pools.

The CFTC explained the significance of the co-regulation of securities futures as follows:

> The practical consequence of this dual-definition is that boards of trade that are otherwise subject to the regulatory jurisdiction of only the SEC or the CFTC, but which seek to list security futures

products for trading, might now be subject to both regulatory regimes. The CFMA attempts to resolve this potentially duplicative regulation by preserving the jurisdiction of an entity's primary regulator and reducing the jurisdiction of the other regulator. Accordingly, under new section 5f of the Act, a board of trade that is primarily regulated by the SEC and that seeks to list security futures products for trading is relieved from certain of the CFTC's otherwise applicable regulatory requirements. Likewise, under section 202 of the CFMA, a board of trade that is primarily regulated by the CFTC and that seeks to list security futures products for trading is relieved from certain of the SEC's otherwise applicable regulatory requirements. [413]

Over the years, CFTC and SEC rulemaking will continue to further define the operation of this system of co-regulation.

Prior to the adoption of the CFMA, the National Association of Securities Dealers was the only national securities association. In order to facilitate the co-regulation of securities futures, the CFMA permits the National Futures Association to adopt streamlined securities requirements and be designated as a national securities association, a step that has occurred.

Floor brokers and floor traders trading stock futures on a futures exchange are exempted from the registration requirements and other provisions of the Securities Exchange Act of 1934. "Dual" trading (in which floor brokers also act as floor traders) is prohibited. [414]

The CFMA directs the SEC and CFTC to consider whether and how to develop a national market system for stock futures. [415] In the meantime, the SEC and CFTC are directed to coordinate their regulation of stock futures. [416] The CFTC and SEC are given authority to adopt rules jointly to permit the offering of stock futures trading on foreign boards of trade to persons in the United States. [417]

The regulation of securities futures is exclusively federal. The CFMA preempts state gambling laws and blue sky laws with respect to securities futures. [418] Although the state securities laws are preempted, there is no preemption of state antifraud laws of general application. [419] In addition, the CFMA preempts most state anti-bucket shop laws with respect to securities futures. [420]

[D] Listing Requirements for Security Futures Products

The CFMA mandates transaction fees for transactions in securities futures. The legislation bans options on security futures for three years, and thereafter the SEC and CFTC may jointly determine whether to permit such transactions. The SEC's restrictions on short sales are not applicable to security futures. [421]

In summary, the following listing standards [422] apply to securities futures products:

1. The securities underlying the security futures must be registered under Section 12 of the 1934 Act and must be based on common stock or such other equity securities as the SEC and the CFTC jointly determine appropriate;
2. If the security futures are not settled in cash, arrangements must be made with a clearing agency registered under the securities laws for payment and delivery;
3. The listing requirements must generally be "no less restrictive than comparable listing standards for options" trading on a securities exchange;
4. There must eventually be linked and coordinated clearing to allow offset across markets trading the same stock futures; [423]
5. Broker-dealers in securities futures must be subject to suitability rules that are "comparable" to those applied to securities trading by national securities associations;
6. Dual trading must be prohibited; [424]

7. Securities futures must not be readily susceptible to manipulation;
8. There must be procedures put in place to coordinate surveillance with other markets trading the same securities futures as well as with any markets trading the underlying securities; the surveillance must be designed to detect both manipulation and insider trading;
9. There must be requirements for an audit trail to support the coordinated market surveillance;
10. The various markets involved must provide procedures for coordinated trading halts; and
11. The statutory margin requirements must be met.

In 2001, the Commission adopted regulations implementing the listing standards for security futures products. [425]

In 2006, the SEC and CFTC adopted rules permitting trading in futures on narrow-based debt security indexes and debt security futures. [425.1] A debt security index will not be considered narrow-based when: each index component is a security that is a note, bond, debenture, or evidence of indebtedness and none is an equity security; the index comprises more than nine securities issued by more than nine non-affiliated issuers; the securities of any issuer included in the index do not comprise more than 30 percent of the index's weighting; the securities of any five non-affiliated issuers included in the index do not comprise more than 60 percent of the index's weighting; and the issuer of a security included in an index satisfies specified additional requirements. [425.2] The rules for narrow-based debt security indexes differ from those applicable to equity securities. The SEC-CFTC adopting release noted that "the modified criteria addressing diversification and public information about, and marketing familiarity with, the issuers of the securities underlying a debt securities index will reduce the likelihood that futures on such an index would be readily susceptible to manipulation and thus are more appropriate criteria for debt securities indexes." [425.3]

It is not clear at this time whether all forms of "affiliation" affect the new SEC/CFTC standards for security indices. For instance, the federal government issues debt securities through many different enterprises and their market behavior can differ widely, and yet all are affiliated with the same source. The SEC and the CFTC may need to clarify the scope of the "affiliation" concept not only in the case of domestic government security indices but also for foreign government debt security indices where a similar variety of bonds and notes exists.

[E] Additional Provisions Applicable to Security Futures Products

The CFMA contains additional provisions relating to securities futures. Those provisions are described below.

***Broker-dealer insolvency protections.*—**A brokerage customer's securities futures investments are protected by the Securities Investor Protection Corporation (SIPC) that applies generally to insolvent securities dealers. [426] However, if the entity trading the contracts is a futures commission merchant that is not otherwise covered by SIPC, the segregation of funds required of the Commodity Exchange Act will be the only protection for participants. [427]

***Tax treatment of securities futures.*—**The CFMA also addressed the taxation of securities futures. The taxation of securities futures differs from the types of treatment for a futures contract (60 percent long-term and 40 percent short-term) capital gain treatment. Favorable treatment is available only for dealers in securities futures and not ordinary traders, although such favorable tax treatment is available for ordinary traders of commodity futures. [428]

***Securities laws.*—** Section 2(a)(3) of the 1933 Act provides that any offer or sale of a security futures product by or on behalf of an issuer of the underlying security constitutes a sale of the underlying security. [429] It follows that a sale of a security futures product on or on behalf of an issuer must be registered under the 1933 Act unless an exemption is available. [430] SEC Regulation M [431] prohibits a participant in a securities distribution from purchasing the security being offered in the distribution. [432] With the adoption of the CFMA, Regulation M was amended to cover the purchase of a security futures product where the underlying security is in distribution. [433] SEC Rule 14e-5 prohibits not only purchases of the securities subject to a tender offer but also of any securities immediately convertible into such security. [434] In contrast to the purchase of an option, a security futures product is not immediately convertible into the underlying security. [435] However, if the futures contract expires before the termination of the tender offer, then the purchase of a security futures product will be precluded under SEC Rule 14e-5. [436] Section 16(a) of the Securities Exchange Act [437] imposes reporting requirements and prohibitions on short swing profits on officers, directors and 10 percent beneficial owners of a class of equity security of public companies. The SEC has explained that security futures products do not count in computing someone's long position in the securities until the contract reaches the settlement date. [438] The same is true for calculating the 5 percent ownership threshold that triggers the filing requirements of section 13(d) of the 1934 Act. [439]

[F] Evaluation of the Security Futures Market [439.1]

Notwithstanding the change in the law ushered in by CFMA that now permits futures contracts on individual securities, the stock futures market had a slow start but began to gain momentum in 2006. Co-author Johnson has been associated for a generation with a ban on these products known as the Shad-Johnson Accord, but was delighted when they were freed for trading in year 2000. Co-author Johnson never had a grudge against single security futures, just an obstinacy against sharing regulatory jurisdiction over any type of futures product with other federal or state agencies (which was what was being demanded for single security futures by the SEC). At the time of the 1981 accord, it also helped, that no one was interested in trading them at the time. After many years, successors at the CFTC disagreed and, as described in the preceding sections of this treatise, single stock futures are now subject to joint regulation between the CFTC and the SEC.

When single stock futures were first launched in the fall of 2002, predictions of instant success were bountiful. It seemed a bit odd that no existing exchange added single stock futures as a listed product; instead, they formed joint ventures as if to construct a firewall in case of failure. And the regulatory (more accurately, *co*-regulatory) restrictions imposed by the CFTC/SEC alliance did not help encourage single stock futures. Unnecessarily high initial margin levels, inflated tax rates, and the first-ever federal user fee in the futures business all presented hurdles to stock futures markets. But, if this was indeed the “better mousetrap” as many people believed, these obstacles could probably be surmounted. Two joint ventures were formed to trade single stock futures. One ceased operating after just two years. The other continues to operate but, even after absorbing the volume from its former rival, has been unable to garner more than one-sixth of one percent of total U.S. futures volume despite offering about 200 different single stock futures contracts.

What (else) went wrong with single stock futures? One possibility is that futures contracts fare best if they meet a natural hedging need in the commercial world. Not only do such contracts serve a noble social purpose despite keeping company with hordes of market “speculators,” but hedgers are a loyal group that will provide volume and liquidity during all economic times. Speculators, on the other hand, can be seen as fickle people who flit from product to product in search of excitement (and wealth) and cannot be relied on to support a contract if it begins to look “boring.” The fidelity of loyal hedgers, the authors believe, makes a huge difference regarding whether a product succeeds or fails. Farmers will hedge their crops in Chicago, Kansas City, or Minneapolis; energy companies will hedge in New York and London; bankers will hedge their currency and interest rate exposures in Chicago, etc., even in slow markets. So, is there a parallel hedging demand for single stock futures contracts?

What is “investing”? The stocks underlying single stock futures contracts are generally regarded as “investments” that are chosen over other things—vacations, refrigerators, sky-diving—because they have the potential to grow in value over time. The *whole purpose* of investing is to capture as much as possible of the up-swing in value if it occurs. But there are clearly some risks involved. That is why most investment occurs with *discretionary income*, remaining after life's necessities have been cared for. This combination of greed and “mad money” suggests a different risk profile from normal commercial sensitivities, one which is willing to take a chance because the potential riches are great and any unfortunate losses are affordable.

What is "hedging"? Hedging, especially using futures contracts, provides protection against loss but at the expense of sacrificing upside gain. This product is very attractive to those who cannot afford to suffer loss and are content to limit their potential gain as the price of safety. The rural agricultural producer is concerned about losing the farm, not "hitting the jackpot." Now, just try to sell a hedge to our "investor." First, he or she will tell you that his or her money is in the market because of the hope to become wealthy and that he or she is not prone to give up *any* of that potential without a compelling reason to do so. Second, the investor will explain that the risk of loss is not such a compelling reason because he or she is using discretionary income that can be lost without imperiling him, his or her family or business. Finally, the investor will ask why he or she should pay you a second commission, set aside cash as a margin deposit, and have another market to follow when it undermines profit potential in order to assuage a worry he or she does not have.

Of course, not everyone is either "swinging for the fences" or building bomb shelters. Many people,— *cautious optimists*—are willing—within reason—to take risks. For them, however, a convenient product has existed since the early 1970s— *stock options*. For the cautious optimist, stock options are the perfect solution because they have a defined cost and, if the stock depreciates, your counterparty has to accept those losses. But, if the stock moves in the desired direction, you simply discard the option and keep all of the profit accruing after the option's cost has been recouped.

Is it possible that single stock futures have struggled because no one really wants them? Or, is it possible that the regulators did not need to impose handicaps after all because the market for single stock futures contracts was not there to begin with?

In 2005 and 2006, however, trading volume for single stock futures became more robust, and in 2007, single stock futures contributed to the most powerful drivers of growth in the global volume of futures and options trading. [439.2] New strategies appear to have emerged and, with them, new users. In any case, while the long-range future of these products remains uncertain, as of 2006, there seems to be a hope for them that seemed lost only a few months earlier.

[10] Commodity Options

Commodity options tend to fall conceptually into one of three categories: (1) options to acquire futures contracts of American origin; (2) options to acquire futures contracts traded abroad; and (3) options to acquire the actual commodity. The Commodity Exchange Act encompasses all three forms of commodity options. [440]

A commodity option vests a person with the right, for a specified period of time, to either buy or sell the subject of the option at a predetermined price. [440.1] The option will expire at the end of the period unless the person exercises his or her right to complete the transaction. The holder of an option to buy is said to have a *call* option, while a right to sell is commonly referred to as a *put* option. [441] The creator of the option is called a *writer.* The agreed-upon price at which the right may be exercised is the *strike price.* Finally, the writer of an option receives immediate compensation for doing so, which is the *premium.*

A typical example of a commodity option transaction is as follows: A person purchases from a writer (or from a previous purchaser) an option to buy 1,000 ounces of .999 fine silver at a strike price of $8 per ounce. He pays a premium to the writer (or his predecessor purchaser) of, say, $500 as compensation for that person's willingness to convey the option rights. The option will expire, unless exercised, roughly six months hence. To exercise the option, the purchaser must be prepared to pay the full striking price ($8,000), in addition to the $500 premium already paid. Exercise, therefore, involves a total expenditure of $8,500 by the purchaser (plus any incidental expenses). If, within the six-month option life in the case of an "American" option, or at the end of the period for a "European" option, the value of silver increases to more than $8,500, the purchaser may elect to exercise the option and receive the more valuable silver. If the price of silver does not rise to a profitable level, the purchaser will ordinarily let the option lapse. In that event, his or her direct cost is limited to the $500 premium.

Options on futures contracts behave similarly, except that exercise results in ownership of a futures contract. Upon exercise, a book entry is made on the records of the futures commission merchant, the exchange, and its clearing house, reflecting the fact that futures contracts in the commodity have thereby been received and delivered.

Where the opportunity exists to resell the option, however, the holder of a profitable option may have an alternative other than exercise. Within the option period, the holder may convey his option to another party. Because the strike price of the option has already been set at $8 per ounce and cannot be changed, the holder of a profitable option will demand a premium from the party to whom he sells his option. If, for example, silver has increased in value to $9 per ounce (or $1,000 above the total striking price), the holder might demand a premium of $1,000 from a subsequent purchaser. The option remains open, in the hands of a new owner, who hopes to see the value of silver rise still higher. The original writer becomes obligated to the new purchaser (or his successors) for the remaining term of the option.

The uses and trading techniques of commodity options are many and complex. Put options operate in a manner opposite to the above example. A person may acquire from a writer (or previous owner) a right to sell silver at a strike price of $8 per ounce for the six-month period. He, too, pays a premium (e.g., $500) to the writer or previous holder. If the value of silver declines below $7.50 per ounce, he may choose to exercise the option because it is now profitable, or, if possible, he may resell the option and exact a premium comparable to his profit from the new owner of the option. The economics of a put transaction are similar to a short futures contract, described earlier, in that the right to sell silver at higher than its current value allows the holder to enjoy the same benefits as if he or she had acquired the metal at the lower current market price and tendered it at the higher option price.

There are a number of distinguishing features, however, between a commodity option and a futures contract. [442] Most obvious is the holder's right to simply let the option lapse if it is unprofitable. In futures contracts, whether satisfied by offset or delivery, the party is responsible for the total change in value of the contract while he owned it. For instance, if a person acquires a silver futures contract to buy the commodity at $8 per ounce, and the price of silver declines to $6 per ounce during his ownership of the contract, he will be obligated—whether on offset or delivery—for the entire $2 per ounce loss that he has incurred. On the other hand, if the person had acquired a call option in silver under the same price circumstances, he would have the right simply to let the option lapse, and his obligation would be limited entirely to the original premium (in the example, $500) paid when the option was first acquired. For this reason, commodity options are sometimes characterized as limited risk instruments. [443]

Another distinguishing feature between commodity options and futures contracts is the option premium paid as compensation to the writer or seller. An option writer receives the premium as a type of stand-by fee since (unlike the counterparty) the writer must be prepared to complete the transaction no matter how expensive it may prove to be due to changes in market prices. There is no similar fee for a futures contract because the parties have equal and opposite ("symmetrical") obligations and risks. And, unlike futures contracts marketed to the general public, trading in commodity options is not necessarily confined to the organized commodity exchanges. From 1936 to 1982, American contract markets were not permitted to sponsor commodity options. However, in the 1982 and 1986 reauthorization legislation Congress authorized a pilot program and substantially allowed large-scale trading of option contracts on the exchanges.

As noted earlier, commercial and investor interest has centered mainly on three types of commodity options. The first, options on American futures contracts, are permitted, under section 4c(c) of the Commodity Exchange Act, to be traded on and through the facilities of domestic boards of trade designated by the Commission as contract markets for options trading. [444] The Commission has adopted Regulations sections 33.1 to 33.11, [445] which govern option trading on American exchanges. Under this regulatory scheme, the contract markets have developed standardized option contracts that entitle a purchaser to buy or sell a *futures contract* also traded on that exchange; and to a lesser and more limited extent, options directly on nonsecurities have also been made possible. Exercise of the option results in the ownership of the underlying futures contract or physical commodity. These commodity options, like futures contracts, are traded in a competitive manner on the floor of the contract markets or CFTC-approved electronic trading systems. Substitution of the clearing house for the immediate parties occurs, to assure financial integrity of the options and to facilitate offset, among other benefits. The price that is negotiated is the premium, because the strike price (and all other terms of the option) are set by the contract market. Since the pilot program for options trading was adopted and made permanent, [446] trading in commodity option contracts has entered a competitive environment far more intense than ever before.

Contemporaneously with a 1978 statutory ban [447] of most types of commodity options, which followed a spate of fraudulent vendors, the CFTC adopted Regulation section 32.11 to the same effect. [448] This ban remained in effect until the CFTC formulated regulations on the subject. [449]

It should be noted that, as marketed prior to the 1978 ban, it was unclear whether an American investor acquiring an option on one of London's derivatives markets was buying the option directly or a new option written by the American dealer and "covered" or backed by the *dealer's* acquisition of a London instrument. This ambiguity arose because of uncertainty whether members of the London markets who wrote options would acknowledge any obligation to American investors who acquired options from American dealers. The trade in London options also generated much criticism of the sales practices sometimes utilized, and spawned allegations of fraud from both law enforcement agencies [450] and private investors. [451]

Commodity options, of course, are available through many foreign exchanges. Many, if not most, major exchanges in Europe, North and South America, and the Pacific Rim offer commodity options of one kind or another. To be offered in the United States, however, special exemptions had to be sought and procured from the CFTC. [452]

A limited exemption from most of the Act's prohibitions on off-exchange domestic options had long been provided for "trade options," defined as transactions offered only to persons who are producers, processors or commercial users of, or merchants handling, the commodity that is the subject of the commodity option transaction or the products or byproducts thereof, and who are entering into such transaction solely for purposes relating to their business as such. [453] With the incorporation of commodity options into the swap definition under the Dodd-Frank Act, the CFTC revised the existing trade option exemption to provide express relief from the new swap requirements for qualifying trade options. At the same time, the agency also determined to lift the long-standing restrictions on agricultural trade options and to impose new requirements on the offerors of trade options, under which they must either be eligible contract participants or satisfy the commercial participant requirements already applicable to offerees of trade options. [454] In addition, under revised Rule 32.3, trade options must be intended to be physically settled and, if exercised, result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery, and the counterparties thereto must comply with swap data recordkeeping and, in some cases, reporting requirements.

[11] Leverage Contracts

A relatively brief appearance on the commodities scene was made by the leverage contract. This instrument was generally offered to the public by private merchants (leverage transaction merchants, or LTMs) who fixed the terms in advance and whose offerings tended to be fairly standardized. Although there was considerable variability between the programs offered by these LTMs, a general description is possible based on known practice. Regulation of leverage contracts had a roller coaster history. The approach varied from a ban on leverage contracts to proposed regulation as futures contracts, then to regulation as separate and distinct instruments. [475] Although leverage contracts are rarely used today, there is always the theoretical potential for increased activity.

Most leverage contracts were long-term purchase agreements in which the buyer was entitled to receive from the merchant an identified commodity in a specified amount on payment of a price agreed to when the transaction was first entered. Commonly, the buyer made a down payment on entering the contract and thereafter was subject to certain periodic fees or charges by the merchant while the contract remained open. The duration of these leverage contracts was ordinarily far longer than for futures contracts or commodity options—say, five or ten years—and, under CFTC Regulations, must extend for at least ten years in order to enjoy the CFTC's exclusive jurisdiction. [476] Moreover, a leverage contract provided, typically, that the contract must be carried out at some time during its term, although the buyer had the right to choose when to do so.

An example of a leverage contract (although generalizations are difficult) might be as follows: an LTM enters a contract with a person entitling the latter to receive from the merchant, at any time within the next ten years, 1,000 ounces of gold at a per-ounce price of $500. Total contract value, therefore, is $500,000. At the initiation of the transaction, the buyer must tender to the merchant a down payment of a certain percentage of the full contract value—say, 25 percent or $125,000. Thereafter, and until the contract is completed, the buyer is obligated to pay periodic fees to the merchant, such as on a quarterly basis. In addition, demands for additional funds may be made by the merchant, similar in concept to the futures margin. Not later than the termination date of the contract, however, the buyer is expected to complete the purchase of the gold.

Often, the leverage contract merchant will express a willingness to buy back the contract from the purchaser, although the merchant must stop short of guaranteeing to do so. [477] In the event of repurchase by the merchant, the price at which this will be accomplished is generally set by the merchant.

The economics of a leverage contract transaction were similar to those of a futures contract. If the market price of gold rises, in the example above, $500 per ounce and sufficiently higher to cover the purchaser's interim expenses (such as the merchant's fees), the purchaser may complete the transaction or request the merchant to buy back the contract. If the market price of gold does not rise to profitable levels, however, the merchant may nevertheless insist on the purchaser's performance or agree to buy back the contract at a loss to the original buyer.

The merchant as well as the buyer, of course, is at risk during the term of the leverage contract. If the price of gold rises to a level profitable to the buyer, the merchant could be forced to acquire higher-priced gold and deliver it to the buyer at the lower contracted price, or the merchant may have to remit much of the profit to the buyer if a buy-back is effected. To protect against this risk, a prudent leverage contract merchant would often seek to cover his risk by some means, such as ownership of gold or by acquiring a long position in gold futures contracts on one of the organized commodity exchanges where such trading takes place. Other means of cover could include options or forward contracts with gold suppliers. Outright ownership of gold equal to a merchant's outstanding obligations entails great expense, of course, and it is predictable that a merchant will cover his risk through less expensive means, if available. For example, a gold futures position can be acquired initially for a margin rarely exceeding 10 percent of the gold's value, and gold options carry a premium far less than the gold's full value. CFTC Regulations now require that an LTM's obligations be covered at all times to assure its ability to perform; and at least one-quarter of that cover must be in futures or commodity options. [478]

Experience suggests that ultimate fulfillment of a leverage contract through delivery of the underlying commodity has been uncommon and that a buy-back by the merchant is typical. Indeed, leverage contracts were often promoted (or perceived by buyers) as a way to invest in commodity price changes, and many buyers harbor no desire to gain actual ownership of the commodity. [479]

In the 1974 amendments to the Commodity Exchange Act, the Congress considered folding leverage contracts into the regulatory sphere of the new Commission. The result was section 217 of the Commodity Futures Trading Commission Act of 1974. [480] Section 217 prohibited any person from offering, entering into, or confirming the execution of "any transaction for the delivery of silver bullion, gold bullion, or bulk silver coins or bulk gold coins" if the transaction was "pursuant to a standardized contract commonly known to the trade as a margin account, margin contract, leverage account, or leverage contract" if that transaction occurred "contrary to any rule, regulation or order of the Commodity Futures Trading Commission designed to insure the financial solvency of the transaction or prevent manipulation or fraud."

Section 217 applied, of course, only to transactions of the described nature in two commodities—silver and gold—and only if offered as bullion or bulk coins. Moreover, the Regulations that the Commission was authorized to promulgate under section 217 were to focus on three concerns: financial solvency of the transaction, manipulation, and fraud. [481]

At the time of the enactment of section 217, leverage contracts were neither well known "to the trade" (if that phrase meant the long-established commodity community), nor to Congress. In particular, Congress did not choose to pass on the question whether a leverage contract might, in fact, be a futures contract more properly governed by the general Act provisions relating to futures. (Indeed, the decision of Congress to absorb leverage contracts into the Act suggests that it perceived, and perhaps was encouraged by section 217's proponents to see, a similarity between leverage contracts and traditional futures.) Accordingly, section 217 provided that "If the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, as amended, such transactions shall be regulated in accordance with the provisions of such Act. [482]

The Commission did not immediately exercise its authority to adopt comprehensive regulations governing leverage contract transactions after 1974, although it adopted a Regulation section 30.03 (now Regulation section 31.3) generally prohibiting fraud, deceit, and misrepresentation in connection with such transactions. [483]

In 1978, when the Commodity Exchange Act was again substantially amended, Congress took several steps to refine section 217. First, it formally incorporated section 217, with revisions, into the Act as new section 19. [484] Second, it prohibited outright any leverage contracts in the agricultural products now listed in section 1a of the Act. Third, it expanded the coverage of the section to embrace all other commodities (in addition to gold or silver bullion and bulk coins). Fourth, Congress extended the coverage of the section to include, in addition to leverage contracts, as then known, "any contract, account, arrangement, scheme or device that the Commission determines serves the same function or functions as such a standardized contract, or is marketed or managed in substantially the same manner as such a standardized contract." This broader coverage reflected Congress's continued concern over the nearly limitless permutations that these contracts might take and seemed to want to make clear that the section might cover arrangements that were not necessarily standardized.

Section 19 (formerly section 217), by its terms, continued to and now, once again, authorizes the Commission to adopt regulations to protect against financial insolvency, manipulation, or fraud in regard to gold and silver transactions, but says nothing about the possibility of a Commission ban on them. This distinction is noteworthy because Congress, in its revision of the section in 1978 to embrace leverage contracts in other commodities, expressly authorized the Commission to "prohibit or regulate" transactions in these other commodities if standardized contracts are involved. A ban on leverage trade in gold and silver might have been achieved as a practical matter, however, if the Commission had determined that they were "futures contracts" under the Act that, accordingly, could only be offered through designated contract markets.

During 1978, the Commission took steps to implement its right to ascertain whether leverage contracts are really futures contracts. In December of that year, the Commission adopted former Regulations sections 31.1 and 31.2 imposing a "temporary moratorium" on new entrants into the leverage contract business. [485] In its Regulation section 31.1, [486] the Commission prohibited gold or silver leverage transactions by anyone not so engaged on June 1, 1978. In Regulation section 31.2, [487] leverage contract dealings by merchants in other commodities were foreclosed unless those persons were in the business on February 2, 1979. Exceptions could be made by the Commission for new firms under certain limited circumstances where hardship would otherwise result and adequate customer protection was present. [488] The temporary moratorium was imposed for the express purpose of allowing time for the Commission to determine "whether leverage transactions, or any class thereof, are contracts for future delivery within the meaning of the Commodity Exchange Act and should be regulated accordingly, or are not contracts for future delivery and the Commission adopts appropriate registration, financial, recordkeeping, disclosure or other regulations as necessary in order to provide adequate customer protection. [489]

Subsequently, in early 1979 the Commission published for comment a proposal to exercise its authority under section 19 of the Act to ban completely any leverage contract transactions in commodities other than silver or gold bullion and bulk coins. [490] The Commission cited "the highly speculative nature of leverage transactions other than those involving gold and silver," as well as congressional concern expressed in the 1978 legislative process, and the Commission's experience in regulating other off-exchange transactions. [491] In March 1979, the Commission solicited public comment on whether all presently known leverage transactions should be declared to be futures contracts, a position urged by its Office of General Counsel. [492] In its opinion, the Office of General Counsel took the position that any contract containing a future delivery feature should be considered a futures contract unless it involves "commercially motivated cash commodity sales, which contemplate actual delivery of the commodity, but in which delivery may be deferred for purposes of commercial convenience or necessity." [493] The Commission, in July 1979, announced its intention to treat all known leverage contracts as futures contracts. [494]

In 1982, Congress reversed the direction of the CFTC by eliminating the ban on leverage contracts and replacing it with a mandate that the CFTC regulate leverage contracts and leverage transaction merchants (LTMs). [495] The 1982 legislation authorized the Commission to permit trading of leverage contracts (except for agricultural commodities subject to the 1978 ban) under appropriate regulations, or, alternatively, to continue the ban if trading were to be found not to be in the public interest. [496] The 1982 legislation also repealed former section 19(d), which permitted the CFTC to prohibit leverage contracts by classifying them as unauthorized futures contracts. [497] However, where a contractual arrangement for deferred delivery resembles a futures contract rather than a leverage contract that would otherwise be permitted, it may still be found to be in violation of the Act. [498] The essential characteristics of a leverage contract have been defined as follows:

> (1) A standardized agreement prepared by the seller; (2) an initial down payment, usually a percentage of the purchase price; (3) purchase price determined by the seller; (4) varying terms of contract, some as long as 10 years; (5) interest usually charged on the unpaid balance of the purchase price; (6) requirement of margin maintenance; (7) usually no actual delivery of the underlying commodity. [499]

This is to be compared with the broader, more generalized description of contract for future delivery. [500]

Under its 1982 congressional mandate, the Commission promulgated rules regulating the conduct of LTMs. [501] LTM regulation is similar to the registration and antifraud provisions that are applicable to future commission merchants (FCMs). [502] Two firms qualified as LTMs under the CFTC's rules and in 1986 Congress imposed a two-year moratorium on additional LTMs pending a study by the CFTC. [503] The moratorium was viewed as a reasonable alternative to either granting a monopoly to the existing firms or putting them out of business pending a determination of the viability of continued legalized leverage transactions. [504]

In addition to the moratorium on additional LTM registrations, the 1986 legislation deleted the expanded authority that was added to section 19(b) in 1982 to regulate leverage contract transactions beyond gold and bullion. [505] The clear effect of the legislation is to permit only leverage transactions "for the delivery of silver bullion, gold bullion, bulk silver coins, bulk gold coins, or platinum." [506] Furthermore, as is the case with futures contracts, these leverage contracts can be traded only if standardized in accordance with applicable CFTC rules. [507]

The Commission brought the regulation of LTMs in line with the regulation of other commodities professionals. Effective January 1990, the Commission's registration functions for LTMs have been delegated to the National Futures Association (NFA). [508] Accordingly, the NFA now has the responsibility for processing registration applications of LTMs and their associated persons (APs). [509] As a result, the NFA has the authority to deny, condition, suspend, restrict, or revoke the registration of LTMs and their APs as well as to process requests for withdrawal. [510] The NFA was also given rule enforcement authority over LTMs and their APs with regard to the establishment of minimum financial solvency, cover, segregation of funds, sales practices, and reporting requirements. Additionally, the NFA is now responsible for conducting arbitration proceedings relating to claims and grievances by LTM customers.

Activity in leverage contracts has subsided markedly and may never reemerge to justify the huge investment made by Congress and the Commission in developing an appropriate regulatory regime for them. Should leverage contract trading resume, however, a comprehensive regulatory program awaits it.

[12] Cash or Spot Transactions

The vast majority of mercantile transactions in commodities are for immediate or near-immediate delivery. The plain object of the transaction is to convey the commodity to a buyer wishing to receive it. Unlike most futures contracts, commodity options and leverage contracts where delivery is possible but unlikely to occur, a cash or spot transaction will result in actual conveyance of the commodity in the great majority of cases. For that reason, parties to these transactions can usually be identified as producers, processors, dealers, or consumers of the commodity in question.

Shipment or delivery need not be immediate, however, for a spot transaction to occur. Section 1a of the Commodity Exchange Act clearly recognizes that such sales may entail "deferred shipment or delivery." [511] The test of a spot sale is whether, in the contemplation of the parties, ownership of the actual commodity is intended to pass even though actual possession may be delayed. Thus, for example, a grain exporter may sell wheat to a foreign buyer that cannot be delivered until ocean transport is procured, or at the request of the buyer, a seller may defer shipment until the buyer can obtain suitable warehousing space. Of course, country grain elevators frequently buy part of the farmer's crop prior to harvest.

In the *Zelener* case, [511.1] the Seventh Circuit held that a roll-over provision in a currency contract did not cause the contract to be a futures contract. The *Zelener* decision was effectively reversed by the 2008 Act amendments, further bolstered by the Dodd-Frank Act and CFTC interpretations thereof. [511.2] In contrast, contracts for future delivery will invoke the CFTC's jurisdiction. [511.3]

Nor does the fact that the sales contract may stipulate conditions under which the obligations may be excused have the necessary effect of defeating its spot character. Provisions such as force majeure clauses can be found in many forms of commercial sales agreements. Likewise, parties may agree to liquidated damages in lieu of performance under specified circumstances. As long as these alternatives to conveyance of the commodity are exceptional, there is little risk that a spot transaction will be perceived as a futures contract, option, or similar instrument. Thus, when a contract does not call for delivery at a fixed price but rather calls for a delayed delivery at the market price, it is a spot transaction and thus not subject to the Act not the Commission's jurisdiction. [512]

Even though transactions and contracts for a commodity in the spot markets are not subject to regulation under the Act, manipulation of those markets is within the Act because the manipulation can have an effect on the futures and derivatives markets. [512.1] The Commission has successfully exerted jurisdiction over false reporting of price information even though the transactions involved are cash transactions rather than futures contracts. [512.2]

On the other hand, a transaction cannot be made spot merely by declaring it to be. On a number of occasions, the true nature of the transaction has been examined and found to be different in character from what it was portrayed to be. [512.3] A vendor of "cash commodities for deferred delivery" was held to be engaged in the off-exchange sale of futures contracts when it was found that those instruments were acquired by the general public to speculate in commodity price changes rather than to receive the commodity itself. [513] Similarly, a contract that is characterized as a "deferred delivery" agreement but that does not obligate the buyer to complete the purchase has been held to be a commodity option rather than a spot sale. [514] A comparable program—marketed as "limited risk forward contracts"—has been found to be, in reality, a commodity option. [515]

While the CFTC used for many years a rather inflexible deliver-or-else test as to what is a cash or spot transaction, [516] it became aware of certain deferred delivery arrangements in the crude oil business where a particular cargo might change hands dozens of times before coming to rest with the ultimate buyer. At least one court held that such transactions are futures contracts because the great majority of purported "buyers" received nothing (except a cash adjustment based on price movements). [517] The CFTC responded with a special pronouncement on those transactions [518] and later on deferred delivery contracts in general. [519]

Given the various financial products that are not directly under SEC regulation, it is common for some securities broker-dealers to engage in transactions in investment products that are not regulated by the securities laws. One such example is found with respect to foreign currency exchange (forex) contracts, which ordinarily fall under the jurisdiction of the CFTC. In January 2009, FINRA proposed a rule to regulate leverage on retail forex contracts. [519.1] This followed an earlier FINRA notice giving guidance on securities broker-dealer transactions in forex contracts. [519.2] This notice, issued in November 2008, reminded FINRA members that NASD Rule 2110's just and equitable principles of trade applies to dealings in forex contracts. [519.3] FINRA also stated its position that NASD Rule 2210 regarding misleading communications with the public is not limited to securities transactions and thus would apply, for example, to communications relating to forex contracts. [519.4] FINRA also announced that it considers expansion of a broker-dealer's business into forex contracts to be a material change in business operations within the meaning of NASD Rule 1010(i). [519.5] In addition, FINRA's net capital and customer protection calculations must take forex contracts into account. [519.6] The anti-money laundering rules must also be considered with respect to forex transactions. [519.7] In addition, there have been a number of enforcement efforts with respect to securities broker-dealers transactions involving non-securities investment products. [519.8]

[12A] Swap Transactions; Market Reform and Swap Dealer Regulation

[A] [Reserved.]

[B] Regulation of Swaps—Definitions, Swap Dealers, and Major Swap Participants

On July 21, 2010, the President signed into law the Wall Street Transparency and Accountability Act as Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, [519.9] amending substantially the Commodity Exchange Act as well as major provisions of the laws administered by the SEC. [519.10] The principal thrust of the new legislation is to subject to federal oversight and regulation the huge market [519.11] in over-the-counter ("OTC") derivative instruments, collectively referred to as "swaps." The objective of these changes is mainly three-fold:

- To bring as many of these transactions onto visible, open trading platforms as possible, taking into account that some agreements will have terms that are so unique that they cannot be centrally traded;
- To create a steady and comprehensive flow of trading data so that market participants are broadly informed of transactions and related activities; and

- To buttress credit support for these transactions by channeling as many as possible into clearinghouses and other central credit counterparties that will add their large resources to any defaults that might occur.

With the exception of credit default swaps, [519.12] the swaps community appears to have contributed little to the recent financial markets crisis. However, the Congress came to recognize that the OTC derivatives had been operating with perilously little oversight by financial authorities and, for its size, could pose a systemic risk to the economy in the future unless it were better and more objectively supervised.

The Act sets forth a broad definition of swap transaction [519.13] and continues the distinction under prior law between security-based swaps [519.14] that are subject to SEC jurisdiction. The new legislation [519.15] broadly defines a "swap" to include:

- Any form of option for the transfer of a thing of value [519.16] or that tracks the value of that thing
- Any agreement where performance depends on a contingency associated with a potential financial, economic, or commercial consequence
- Any agreement calling for payment based on the value or level of a referenced thing but without entitling either party to ownership of the thing, or
- Any other instrument "commonly known to the trade" as a swap.

In July 2012, the CFTC and SEC adopted final rules defining the terms "swap," "security-based swap," and "mixed swap." [519.17] The dividing lines between swaps and security-based swaps are based upon the product underlying the transaction. If an instrument otherwise satisfies the definition of a swap and the underlying product is a commodity or a broad-based security index, then the product is a swap subject to CFTC jurisdiction. However, if the underlying product is a narrow-based security index, a single security or loan, or an occurrence, non-occurrence or extent of an event relating to a single issuer of securities or the issuers of securities in a narrow-based index, then the product is a security-based swap subject to SEC jurisdiction. The CFTC and SEC have joint jurisdiction over "mixed swaps," which are instruments that materially reference both swap and security-based swap underliers. Due to the complexity and technicality of the rules, the CFTC and SEC provided a means for market participants to request a joint interpretation regarding the characterization of a particular instrument.

Much of the agencies' release accompanying the definitional rules provides guidance concerning the status of particular products as swaps or security-based swaps. The release discusses the definitional carveouts for forward contracts on non-financial commodities, insurance products, consumer and commercial agreements and certain loan participations. The CFTC made clear that it intends to apply its long-standing "Brent Interpretation" to the forward contract exclusion, such that a transaction between two commercial market participants would qualify as a forward contract if the parties originally intended to deliver the commodity and assumed the risk of having to make or take delivery under the contract, even if they enter into a subsequent contract that extinguishes the delivery requirement. Forward contracts containing embedded options will be considered excluded forward contracts if the embedded options meet certain requirements. A forward contract with volumetric optionality will qualify for the forward contract exclusion if it satisfies a seven-part test.

The joint rulemaking clarifies that certain insurance contracts are not swaps or security-based swaps, provided that they qualify for a safe harbor relating to the nature of the product and the issuer and also confirms that surety bonds, fidelity bonds, health insurance and other specified forms of insurance provided pursuant to state or federal insurance regulation will not be deemed to be swaps or security-based swaps. In addition, certain consumer and commercial transactions will not be considered to be swaps or security-based swaps where the payment obligation is not severable from the agreement itself, the agreement is not traded on an organized market or over-the-counter and, the agreement involves a consumer asset or service purchase or serves an independent commercial purpose, other than to transfer risk. Loan participations are not swaps or security-based swaps if the participant acquires a current or future, direct or indirect, ownership interest in the related loan or commitment, provided that certain other conditions are met.

The release also addresses various types of agreements that will be considered to be swaps or security-based swaps. Somewhat controversially, the CFTC determined that guarantees of swaps are swaps and implied that this interpretation will apply whether a guarantee is a full, limited or partial guarantee. The CFTC noted, however, that it will propose a rule relating to swap guarantees. Similarly, the SEC determined that guarantees of security-based swaps are securities and will be subject to certain reporting requirements, to be proposed in a separate rulemaking.

Notwithstanding the Treasury Secretary's determination to exempt foreign exchange swaps and foreign exchange forwards from treatment as swaps for most purposes, several other foreign exchange products are swaps for all purposes. [519.18] These products include foreign currency options, non-deliverable forwards in foreign exchange, currency swaps and cross-currency swaps, and options on foreign exchange forwards and swaps.

In addition to defining swaps broadly, the Act sets forth a series of exclusions from the definition of swap. [519.19] Those exclusions include futures contracts, options on futures contracts, "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." [519.20] The legislative history makes clear that this exclusion was designed to parallel the pre-existing exclusion of forward contracts [519.21] in the Commodity Exchange Act and the CFTC's policy on forward contracts. The Act also excludes from the swap definition: securities options, foreign currency options traded on a national securities exchange, fixed basis or contingent basis contracts for the purchase or sale of a security unless the contract is a credit default swap, notes, bonds or evidences of indebtedness that are securities, agreements based on a security and entered into directly or through an underwriter by the issuer of such security for the purposes of raising capital, and security-based swaps other than security-based swap agreements as defined in the Gramm-Leach-Bliley Act. [519.22]

The SEC has primary jurisdiction over security-based swaps, which include credit default swaps and equity swaps on a single security or a narrow-based index of securities or on a single loan. Thus, under the new framework, the CFTC has jurisdiction over the vast majority of the swaps market, including interest rate swaps, foreign exchange derivatives, commodity swaps, and credit default swaps and equity swaps on broad-based indices.

The Act mandates that subject to an exemption for end users, swap contracts must be cleared through a designated clearing organization if the CFTC determines that the swap is of the type that must be cleared by a derivatives clearing agency. Also, the swap must be traded on a designated contract market or swap execution facility if the contract market or facility makes the contract available for trade. Before implementation of the CFTC rules implementing mandatory clearing, swaps may continue to be created subject to Commission approval. Also, swaps entered into prior to Dodd-Frank or subsequent to the new law but prior to implementation of mandatory clearing are grandfathered from the mandatory clearing requirement. [519.23]

As noted above, there is an exemption from the clearing and exchange trading requirements for non-security-based swaps that will be available to counterparties who qualify as end users. The end-user exemption applies to a counterparty who (i) is not a financial entity, (ii) is hedging its own commercial risk, [519.24] and (iii) notifies the Commission, as required by CFTC regulation, how it generally meets its financial obligations associated with entering into uncleared swaps. [519.25] The end user determination is not entirely straightforward.

In 2012, the Commission adopted its regulation dealing with the end-user exception. [519.26] Rule 39.6 sets forth the requirements for electing this statutory exception from clearing reporting for end users. [519.27] Rule 39.6 lists criteria for determining whether a swap transaction hedges or mitigates commercial risk. The regulation sets forth the information that must be reported by counterparties in order to satisfy the notification requirement. Rule 39.6 also establishes an exception from the clearing requirement for small financial institutions. [519.28] Additionally, the regulation provides rules and a discussion relating to the application of the end user exception to certain types of swaps and entities. The end user exception regulation did not adequately address exceptions from the clearing requirement with respect to inter-affiliate trades, centralized hedging units and captive finance entities. Shortly after the original regulation was adopted, the Commission proposed an inter-affiliate clearing exemption. [519.29] As noted elsewhere, it is likely that qualified end users will not be subject to mandatory margin requirements imposed by regulation on cleared swaps and thus will be subject to the margin requirements that may be negotiated with their counterparties. [519.30] One likely result of the new regime will be increased costs of hedging transactions including the capital charges to be imposed upon swap dealers in connection with uncleared swap transactions. In addition, the limitations on banks' derivatives activities, may reduce competition in the OTC derivatives market.

The Dodd-Frank Act created two new categories of professionals that must be registered under the Commodity Exchange Act. Those two new categories are (1) swap dealers and (2) major swap participants. In 2012, the CFTC and SEC adopted final rules interpreting the statutory definition of “major swap participant,” and “major security-based swap participant” contained in the Dodd-Frank Act. [519.31] Major swap participants are persons other than swap dealers (i) who maintain a substantial position in swaps for any of the major swap categories, excluding positions held for hedging or mitigating commercial risk; (ii) whose outstanding swaps create substantial counterparty exposure that would have serious adverse systemic effects; and (iii) financial entities that are highly leveraged, not subject to capital requirements imposed by federal banking regulators and maintain a substantial swap position. The joint CFTC-SEC rules specify the thresholds for and calculation methodology for applying these standards. Swap dealers and major swap participants are required to register under the Act and are made subject to an array of substantial duties, including capital and margin requirements, expensive reporting and recordkeeping, business conduct standards, disclosure duties, risk management obligations, and many other operational mandates. The specifics and implementation of the regulation will be unveiled by CFTC rulemaking. For example, in July 2011, the CFTC amended its regulations to apply its large trader reporting requirements to swap dealers and clearing members dealing with physical commodity swaps. [519.32] The CFTC also adopted rules regarding mandatory clearing of swap transactions. [519.33]

The Dodd-Frank Act also expanded the CFTC's authority with respect to position limits by authorizing the Commission to establish position limits for contracts economically equivalent to futures contracts on physical commodities, including swaps. [519.34] The CFTC has stated that it interprets the Act to require it to: (1) limit the number of positions, other than bona fide hedge positions, that may be held by any person with respect to futures and option contracts on physical commodities other than excluded commodities traded on or subject to the rules of a DCM, as appropriate, and (2) establish position limits for swaps that are economically equivalent to futures contracts on physical commodities other than excluded commodities (collectively, “economically equivalent swaps”). [519.34a]

Many of the CFTC's rulemakings have sparked controversy and several cases have been filed to date to contest their validity. In 2012, in response to a challenge by industry trade associations, a D.C. district court struck down the CFTC's speculative position limit rulemaking (the “Vacated Rules”). [519.35] Challenges were also made to the CFTC's adoption of amendments to Rule 4.5, relating to the treatment of mutual funds as commodity pools, and to its rules establishing minimum margin requirements for cleared swaps transactions. In June 2013, the D.C. Court of Appeals affirmed a district court decision dismissing the lawsuit challenging Rule 4.5, finding that the CFTC's rule amendments were not arbitrary and capricious. [519.36] Also in 2013, the District Court for the District of Columbia dismissed the challenge to the CFTC's margin rules, holding that the petitioner, the prospective sponsor of a swap execution facility, lacked standing to challenge the cleared swap margin rules. [519.37]

Security-based Swaps

Security-based swaps fall under the SEC's jurisdiction. The SEC regulatory mandate parallels the mandate Congress gave to the CFTC. For example, as it did with the CFTC, the Dodd-Frank Act created two new categories of professionals that must be registered under the Securities Exchange Act. Those two new categories are (1) security-based swap dealers and (2) major security-based swap participants. A "security-based swap dealer" is defined as a person who (i) holds itself out as a dealer in security-based swaps, or (ii) makes a market in security-based swaps, or (iii) regularly enters into swaps with counterparties as an ordinary course of business for its own account, or (iv) engages in activity commonly known in the trade as a dealer or market maker in security-based swaps. [519.38] "Major security-based swap participants" include any person that is not a security-based swap dealer but maintains "substantial positions in security-based swaps," as jointly further defined by the CFTC and SEC, that create substantial counterparty exposure that could destabilize the U.S. banking system or financial markets. [519.39] Security-based swap dealers and major swap participants that will be required to register under the Exchange Act are made subject to a variety of burdensome duties, including capital and margin requirements, extensive reporting and recordkeeping, business conduct standards, disclosure duties, risk management obligations, and many other operational mandates. The specifics and implementation of the regulation will be unveiled by SEC rulemaking. The Dodd-Frank's mandates for security-based swaps parallel the mandate to the CFTC for all other swaps that are outlined below.

Joint Rulemaking Defining Swaps, Security-based Swaps and Mixed Swaps.

As discussed above, in July 2012, the CFTC and SEC jointly adopted final rules defining the terms "swap," "security-based swap," and "mixed swap." [519.40] These definitions are necessary for a determination whether an instrument falls within the regulatory authority of the CFTC, the SEC, or both. Publication of these definitional rules in the *Federal Register* triggered many key compliance dates for swaps market participants, including registration of swap dealers and major swap participants. Characterizing a particular instrument as a swap, security-based swap, mixed swap, or an instrument that is exempt from swap regulation can present complex issues, many of which are discussed in the agencies' joint release.

Under the Dodd-Frank Act's jurisdictional allocation, the CFTC has responsibility for the vast majority of the over-the-counter derivatives market—all swap transactions except security-based swaps. The new swap definition encompasses, among other instruments, interest rate swaps, foreign exchange derivatives (subject to the exclusion discussed below), commodity swaps, credit default swaps and equity swaps (such as total return swaps) on broad-based security indices or swaps and over-the-counter options that reference interest rates, foreign exchange and other commodities, but not options on securities, certificates of deposit, or groups or indices of securities. The SEC has primary jurisdiction over security-based swaps, which include credit default swaps and equity swaps on a single security or a narrow-based index of securities or on a single loan. The CFTC and SEC exercise joint jurisdiction over mixed swaps, which are instruments that materially reference both swap and security-based swap underliers and, hence, are both swaps and security-based swaps. As stated in the joint release, the scope of this category is intended to be narrow, serving to avoid gaps in the regulation of swaps and security-based swaps. This category would include, for example, "best-of" swap referencing both the price of crude oil and the value of an oil company's common stock.

Some common derivatives are expressly excluded from the definitions of swap, security-based swap and mixed swap. [519.41] Deliverable foreign exchange forwards [519.42] and deliverable foreign exchange swaps [519.43] will be considered swaps unless the Secretary of the Treasury issues a determination that such transactions should not be regulated as such, in which case they will still be subject to business conduct and reporting requirements but are otherwise exempt from swap requirements. In November 2012, Treasury Secretary Timothy Geithner exempted both foreign exchange forwards and "foreign exchange swaps," leaving them subject only to business conduct and reporting rules. [519.44] Foreign exchange instruments that do not qualify for this exemption, including non-deliverable foreign exchange forwards, currency and cross-currency swaps, foreign exchange options, so-called "rolling spot" transactions and contingent foreign exchange forwards, are defined as swaps and subject to all swap requirements. Spot foreign exchange transactions [519.45] are not swaps.

Increased regulation of swaps, security-based swaps and mixed swaps will have a significant effect on the availability, liquidity and pricing of even those instruments that are exempt from such regulation. As the costs, consequences and information transfer inherent in swap transactions change, market participants will need to reassess their choices between standardized instruments and bespoke swaps. For example, based on demand from market participants, several exchanges have recently migrated some energy contracts, previously traded as swaps, to execution as futures contracts, a phenomenon known as "futurization." It is expected that regulatory guidance and market practice regarding the classification of these instruments will develop over time. Classification is important for a wide variety of regulatory purposes—from determining a market participant's registration obligations with the CFTC or SEC to assessing requirements for, and costs of, trading such instruments.

THE NEW REGISTRANTS UNDER THE COMMODITY EXCHANGE ACT

As discussed throughout this treatise, a central feature of CFTC regulation is the licensure ("registration") of persons that are key components in the operation of the markets. Until now, those professionals have included futures commission merchants (FCMs), introducing brokers (IBs), commodity trading advisors (CTAs), commodity pool operators (CPOs), floor brokers (FBs), floor traders (FTs) and associated persons (APs) of the above. [519.46] These registration categories remain intact under the amended Act and, indeed, most definitions have now been expanded to make clear that the particular class of registration entitled the holder to perform the permitted services with respect to swaps as well as instruments already covered by the statute. [519.47] However, while these registration categories remain intact, it is not yet clear whether an existing registrant must also undergo a new registration if its activities overlap with the definition for a new class of registrant. [519.48]

Swap Dealer. [519.49] This new registration category applies to any person that:

- Holds itself out as a dealer in swaps;
- Makes a market in swaps;
- Regularly enters into swaps with others as an ordinary course of business for its own account; or
- Is commonly known in the trade as a dealer or market maker in swaps. [519.50]

It is important to note that swap dealer registration marks only the second time that the Congress or the CFTC has required licensure simply in the capacity as a principal to transactions. Registration of "floor traders" [519.51] has existed since 1992. [519.52] Otherwise, however, the mere fact that a person conducted a proprietary trading business in futures or options did not—until now—involve licensure obligations. Large traders, of course, were subject to reporting duties, [519.53] special calls for trading data, [519.54] and speculative position limits [519.55] but formal registration based solely on being in the business of trading did not exist except for floor traders. Registration is not required for dealers engaging in swaps in limited transactions. The CFTC originally established a de minimis threshold for registration for swap dealers of $8 billion of notional value in swap dealing transactions in a 12-month period. The Commission renewed that threshold in November 2018. [519.55a]

Major Swap Participant. [519.56] This category of registrant includes any person that is not a swap dealer but maintains "substantial positions in swaps," as jointly defined by the CFTC and SEC, that create substantial counterparty exposure that could destabilize the U.S. banking system or financial markets. [519.57] Major swap participants are identified using a complex quantitative test developed by the CFTC and SEC and will be subject to regulation that is generally similar to that of swap dealers. In short, this test looks to the risk a market participant currently poses to its counterparties through uncollateralized out-of-the-money positions and the potential risk the market participant may pose to its counterparties through a risk-adjusted swap notional calculation.

Swap Execution Facility (SEF) . The amended Act allows for the creation and registration of a new trading facility devoted to multilateral transactions in swaps, called a "swap execution facility." [519.58] This status suffices in lieu of full designation as a contract market provided that trading is confined to swaps. [519.59] A designated contract market may also list and trade swaps, or it may operate a separate SEF for the swap component of its listed products if it is made clear which of the two markets is employed for this purpose. [519.60]

Similar to the vetting of a designated contract market, an SEF must demonstrate its ability to comply with strict CFTC standards and "core principles." [519.61] These include a showing that it maintains a rules enforcement investigation program related to trading terms and protocols, participation standards, and market access, and enforces the mandatory clearing obligation where it is applicable. Offerings must be limited to swaps that are not readily susceptible to manipulation and there must be market oversight and supervision to detect disruptive activities. The SEF must have ways to collect any relevant information needed to conduct its operations. It is also contemplated that the SEF will impose speculative position limits "as is necessary and appropriate." [519.62] The provision also requires an SEF to have a system for the clearance and settlement of transactions, the ability to declare and implement market emergency measures, timely electronic capture and publication of trading data, a 5-year records retention program to be shared with the CFTC, [519.63] safeguards against anticompetitive decisions as well as against decision making conflicts of interest, adequate operating resources (set at operating costs for one year), protections to assure trading system adequacy, reliability and recovery, and the designation of a Chief Compliance Officer who reports directly to the SEF's board or its senior executive concerning compliance with these core principles, including an annual report on the subject. [519.64]

In May 2013, the CFTC adopted final rules relating to the registration and operation of SEFs. The new rules define the types of trading platforms required to register as SEFs, the core principles by which they must operate and the execution methods that can be used to satisfy the trade execution requirement in section 2(h)(8) of the Commodity Exchange Act. [519.65] Under the new rules, any trading system or platform that provides more than one market participant with the ability to execute or trade swaps with more than one market participant must register as a SEF, unless it is registered as a designated contract market.

On December 8, 2017, the Commission issued an order that would exempt certain multilateral trading facilities ("MTFs") and organized trading facilities ("OTFs") regulated in the European Union from the requirement to register with the CFTC as SEFs. The order became effective on January 3, 2018. Similarly, the European Commission issued an analogous equivalence decision for CFTC regulated trading venues. As a result of the equivalency agreements, swaps subject to the CFTC's trade execution requirement would be permitted to be executed on the MTFs and OTFs specified in the Commission's order.

In November 2018, the CFTC proposed to overhaul the rules governing SEFs in order to improve market liquidity, transparency, and supervision. [519.65a] The changes would expand the types of swaps required to trade on SEFs, eliminate current strictures on the manner of execution, require interdealer brokers and aggregators of single-dealer platforms to register as SEFs, and establish qualifications and supervisory requirements for SEF employees (which the proposal calls "SEF trading specialists") who perform core functions that facilitate swaps trading and execution for a SEF involved in the formation of swap pricing and other core terms. The proposal would require every SEF to adopt (i) fitness qualifications that prohibit certain persons from acting as SEF trading specialists consistent with the Commodity Exchange Act's statutory disqualifications; (ii) proficiency testing; (iii) ethics training; and (iv) a code of conduct. SEFs would have a duty of supervision over SEF trading specialists. Commissioner Dan Berkovitz voted against the proposed rules on grounds that they (1) would reduce competition and diminish price transparency in the swaps market, leading to higher costs for end users and increases in systemic risks, (2) "abandon the commitments the United States made at the G20 Summit in Pittsburgh in 2009 to trade standardized swaps on exchanges or electronic trading platforms" and are contrary to congressional direction in the Dodd-Frank Act and the CEA reflecting those commitments, and (3) would give SEFs too much discretion to set their own rules. [519.65b]

The Commission voted unanimously to request public comment on whether it should ban the practice of identifying counterparties to cleared SEF swap transactions after the trades have been executed. [519.65c] The Commission refers to this practice as "post-trade name give-up." In February 2019, the Commission extended the comment period for both proposals. [519.65d] It is unclear whether and when the Commission will finalize these rules.

Swap Data Repository **.** [519.66] A major goal of the amended Commodity Exchange Act is to improve the flow of information about swap transactions available to other traders, the public, and policy makers. In the case of designated contract markets, [519.67] derivatives clearing organizations, [519.68] and swap execution facilities, [519.69] there are explicit obligations to publish trading data but, for transactions occurring outside those venues, a new collection and distribution point was deemed to be necessary. Hence, the registered swap data repository as a centralized recordkeeping facility for swap transactions by third parties will fill that void.

The swap data repository is expected to play a significant information function with respect to those transactions that continue to occur privately. The Act recognizes that there exist at least two circumstances where off-market swap transactions may continue:

- Where no designated contract market, derivatives clearing organization or swap execution facility will accept it for execution, [519.70] or
- Where one party meets the "end user" exemption set forth in the Act for commercial hedgers. [519.71]

The exact data elements to be collected and maintained by the swap data repository will be determined by the CFTC. For transaction information collected by this entity, it must confirm the accuracy of the data with each party and give the CFTC direct electronic access. It must also have systems to monitor the data received, including end-user claims of exemption. The privacy of the data is to be observed but it may be shared with other public authorities subject to confidentiality agreements. As this mechanism is expected to be highly automated, business interruption and recovery plans are also required. Finally, a Chief Compliance Officer reporting to the board or senior executive must oversee the program and submit annual reports. Core principles include avoidance of anticompetitive actions and conflicts of interest, transparent governance protocols, and any other standard imposed by the CFTC.

Associated Persons of Swap Dealers and Major Swap Participants **.** This new category closely parallels the "associated person" (AP) definition heretofore applicable to most pre-existing registration classes. [519.72] In general, any natural person who, as a partner, officer, employee, or agent of the swap dealer or major swap participant solicits or accepts swaps or supervises those who do, is deemed to constitute an AP of a swap dealer or major swap participant. [519.73] However, there is no registration process for these individuals, simply a prohibition [519.74] that swap dealers and major swap participants may not hire an AP that suffers from a statutory disqualification under section 8a of the Act. [519.75]

Other New Registrants **.** It appears that the CFTC may require registration of any electronic trading facility where agreements, transactions or contract are executed or traded if the CFTC determines that the agreement is a significant price discovery (SPD) contract, [519.76] by reason of the inclusion of this description in the Act's definition of "registered entity." [519.77] However, while the CFTC has clear authority to include SPD transactions in its calculation of speculative position limits, [519.78] the Act is silent on any formal registration process.

Effects on pre-existing regulated persons. A number of significant changes were made by the Dodd-Frank Act to registration categories that predate its enactment.

Permitted product lines **.** For futures commission merchants, [519.79] introducing brokers, [519.80] commodity pool operator, [519.81] commodity trading advisor, [519.82] floor broker, [519.83] and floor trader, [519.84] the activities authorized in each registration category have been expanded to include swap transactions. It appears that a designated contract market may trade any permissible form of instrument including contracts of sale of a commodity for future delivery, options thereon, options on a commodity and swaps while a swap execution facility must confine its trading activities to instruments deemed to be "swaps." [519.85] And a derivatives clearing organization, like a designated contract market, may clear the full panoply of products. [519.86]

Forbidden products lines. While the Commodity Exchange Act has prohibited trading on a designated contract market in onion futures contracts for roughly 50 years, the Dodd-Frank Act precludes any board of trade from offering futures contracts related to movie box office receipts as well. [519.87] Moreover, the CFTC reserves the right to reject any proposal by a designated contract market or swap execution facility to trade excluded commodities [519.88] tied to any event involving unlawful activity, terrorism, [519.89] assassination, war, gaming, or other matters that the CFTC determines to be contrary to the public interest. [519.90] In 2012, the Commission refused to allow political event and election futures since they were viewed as gaming and not in the public interest. [519.91]

Speculative position limits. For many years the CFTC established and enforced speculative position limits with respect to specific agricultural futures and options contracts [519.92] while the designated contract markets adopted limits for all other commodities. [519.93] The Dodd-Frank Act centralizes that function in the CFTC for all commodities except "excluded commodities," [519.94] including "exempt commodities" [519.95] and "agricultural commodities." [519.96] The CFTC is empowered to set speculative position limits for the same exempt or agricultural commodity with respect to the next expiring delivery or expiration period ("spot month"), any single expiration, and all expirations combined. [519.97] In addition, however, the CFTC may aggregate with futures and options positions other agreements in the same commodity that are either (i) swaps that perform a significant price discovery function [519.98] or (ii) swaps that the CFTC determines to be economically equivalent to contracts on a designated contract market. [519.99] As a result, persons transacting in all of those milieu may have their positions in the same commodity combined by the CFTC for speculative limit purposes.

In November 2011, the CFTC imposed speculative position limits on 28 agricultural, metal, and energy commodity futures contracts, including economically equivalent swaps. [519.100] Bona fide hedges are exempted from the position limits. [519.101]

The designated contract markets [519.102] and the swap execution facilities [519.103] may be required to impose their own speculative position limits as a condition for achieving or retaining that status. Because the CFTC will not impose speculative position limits for transactions in "excluded commodities," [519.104] there is a likelihood that the CFTC will expect the designated contract markets and swap execution facilities to adopt limits for at least those excluded commodities that can become vulnerable to market manipulation or distortion under certain economic conditions. And, to the extent that a designated contract market or swap execution facility adopts speculative position limits for a commodity on which the CFTC has also imposed limits, the private limits may not be more generous than those set by the CFTC. [519.105]

As in the past, speculative position limits are not applicable to "bona fide hedging transactions." However, while the definition of bona fide hedging was previously delegated to the CFTC, [519.106] the term is now defined with considerable specificity in the statute, apparently leaving the CFTC with more limited discretion, largely confining hedge treatment to transactions that substitute for positions to be taken in a physical marketing channel. [519.107] By contrast, CFTC Regulation 1.3(z) [519.108] set forth not only the basic structure of a bona fide hedge but also provided specific examples that do not now appear in the statute. Moreover, Regulation 1.3(z) included a process whereby other transactions could be submitted to the CFTC with a request for a hedge exemption. [519.109] Nothing similar appears in the Act. While there may be sufficient flexibility for the CFTC to maintain some or all of those features going forward, failure to do so would add to the constraints on trading created by the Dodd-Frank Act.

In implementing the new Dodd-Frank position limit authority, the CFTC issued highly controversial position limit rules, which were scheduled to go into effect in October 2012 but were vacated by the U.S. District Court for the District of Columbia in September 2012, in response to a challenge by two industry groups. [519.110] The CFTC initially appealed the District Court's ruling but withdrew its appeal in favor of developing a new set of position limit rules. [519.111]

On December 30, 2016, the CFTC re-proposed a rule to amend part 150 of its regulations to establish speculative position limits for 25 exempt and agricultural commodity futures and option contracts, and physical commodity swaps that are “economically equivalent” to those contracts. Among other things, the proposal would amend the definitions of “futures-equivalent,” “long position,” “short position,” and “spot month” to conform to terminology found in the CEA as amended by the Dodd-Frank Act. It also would amend existing exemptions from speculative position limits, including for bona fide hedging, and update reporting requirements for those claiming an exemption from such limits. [519.111a]

In early 2020, the CFTC withdrew its 2016 re-proposal and issued a new set of proposed changes to its Part 150 position limit rules. [519.111b] As before, the CFTC is proposing to adopt federal position limits for 25 futures and options on futures on physical (i.e., exempt or agricultural) commodities along with swaps that are economically equivalent to such contracts. The proposal would apply CFTC spot month, single-month and all months combined limits to the so-called legacy agricultural futures (and swaps economically equivalent thereto) that are currently subject to CFTC limits, and would increase the single-month and all months combined limits for most of the legacy contracts. In contrast, the CFTC is proposing to adopt federal spot month limits only for the contracts that would newly become subject to federal limits under the proposed amendments. Among other changes, the CFTC is also proposing to (i) revise the bona fide hedging definition and changes to streamline the process for hedge exemptions from position limits, (ii) use a new definition of the term economically “equivalent swaps” that is more tailored than the one it previously proposed, and (iii) changes to rules governing how exchanges set position limits and grant exemptions from their limits. The comment period closed on April 29, 2020.

On December 16, 2016, the CFTC adopted a final rule requiring a person to aggregate positions in accounts (1) for which the person, by power of attorney or otherwise, directly or indirectly controls trading, (2) for which the person, directly or indirectly, holds a 10 percent or greater ownership or equity interest, and (3) for pools held or controlled by such person and which have substantially identical trading strategies, regardless of whether an exemption is available. The final rule provides exemptions for ownership by limited partners, shareholders, or other pool participants and for accounts carried by an independent account controller. [519.111c]

The CFTC's April 2018 settlement with Glencore B.V. and Glencore Ltd. illustrates the aggregation principles. The CFTC's order fined the companies for exceeding position limits in cotton futures. The order found that, because a single trading manager allegedly controlled the futures trading of both affiliates, they must be aggregated for purposes of determining compliance with position limits and, when aggregated, exceeded the limit. [519.111d] Similarly, in a CFTC settlement with McVean Trading & Investments, LLC, the agency sanctioned the respondent for alleged violation of CME position limits based on nonadjudicated findings that the positions of the respondent and others with whom it allegedly acted in concert should be aggregated for purposes of determining compliance with position limits. The CFTC relied in part on the CME rule requirements that positions held by two or more persons acting pursuant to an express or implied agreement or understanding should be aggregated for position limit purposes. [519.111e]

MANDATORY TRADING AND CLEARING OF SWAPS

“Mandatory” centralized trading of swaps. A principal purpose of the Dodd-Frank Act is to migrate, to the maximum extent possible, the trading of OTC swaps and other derivatives onto centralized trading facilities, namely, designated contract markets or swap execution facilities. The Act now requires that all swaps be executed on or subject to the rules of a designated contract market unless transacted between two “eligible contract participants.” However, swaps between eligible contract participants may be traded on either a designated contract market or a swap execution facility. And the Act clearly contemplates that some transactions will have to remain off-market because no designated contract market or swap execution facility will allow it to be traded there. [519.112] End user transactions, which are discussed directly below, are exempt from the exchange trading requirement.

"Mandatory" clearing of swaps. Similarly, the objective of the Dodd-Frank Act is to submit as many swaps as possible to the credit enhancements provided by a derivatives clearing organization. [519.113] The CFTC participates actively in the vetting of swaps to determine whether they should be subjected to clearing [519.114] but cannot compel a derivatives clearing organization to accept any swap. [519.115] In those instances where no derivatives clearing organization will clear the swap even though the CFTC has found it suitable, the CFTC reserves the right to impose margin or capital requirements on the parties. [519.116] Swaps that are not cleared must also be reported to a swap data repository or, if no swap date repository will accept the report, to the CFTC within such time as the CFTC will prescribe. [519.117] For cleared swap transactions where one party is a swap dealer or a major swap participant but the counterparty is not, the counterparty may choose what derivatives clearing organization will be used (subject, of course, to rejection there). [519.118] And for cleared swaps, any carrying futures commission merchant must segregate each customer's swap margin or other deposits [519.119] as was previously required for funds supporting futures and options positions, and such funds enjoy the same protections in bankruptcy as "commodity contracts." [519.120]

An exception from the clearing requirement exists for certain parties (frequently referred to as "end users" in the congressional debates) that are not deemed to be "financial entities" [519.121] to opt out (if they wish) of clearing if their use of swaps is to hedge or mitigate commercial risk and they demonstrate to the CFTC how they generally meet their financial obligations on non-cleared swaps. [519.122] In that case, however, a public company must receive approval to opt out of clearing from an appropriate committee of the issuer's governing board. [519.123] The Act requires swap dealers and major swap participants, at the option of a counterparty (including those electing the end-user exception) to an uncleared swap, to segregate initial margin for the counterparty's benefit at a third-party custodian. [519.124]

In July 2012, the CFTC finalized a rule establishing a schedule for compliance with the mandatory clearing requirements for swaps under Title VII of the Dodd-Frank Act. [519.125] The CFTC's final clearing phase-in rule specifies the time periods between final mandatory clearing determinations and the related compliance dates for swaps entered into between various combinations of counterparty types. "Category 1 entities" include swap dealers, security-based swap dealers, major swap participants, major security-based swap participants, and "active funds." [519.126] Transactions between a Category 1 entity and (i) another Category 1 entity or (ii) any other entity that wishes to clear will become subject to mandatory clearing starting 90 days after publication of a final clearing determination. "Category 2 entities" include commodity pools, private funds, and persons predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature according to section 4(k) of the Bank Holding Company Act, provided that such participants are not third-party subaccounts. [519.127] Transactions between a Category 2 entity and (i) a Category 1 entity (ii) a Category 2 entity or (iii) any other entity that wishes to clear will become subject to mandatory clearing starting 180 days after publication of a final clearing determination. Swap transactions between other combinations of counterparty types (e.g., transactions between Category 1 entities and third-party subaccounts or non-financial end users that are not eligible for or do not elect the end-user exemption) will become subject to mandatory clearing starting 270 days after publication of a final clearing determination.

In November 2012, the CFTC designated for mandatory clearing the first cohort of swaps, which includes two types of credit default swaps (CDS) and several types of interest rate swaps (IRS). [519.128] The clearing requirement will be phased in according to the type of market participants that are counterparties to a designated swap, discussed above. The first clearing requirement under the phase-in began on March 11, 2013. The CFTC has not yet proposed clearing requirements for other swaps in the interest rate or CDS asset classes or for other swap asset classes, including energy swaps, commodity swaps and non-deliverable forwards but may do so in the future.

On October 14, 2016, the CFTC adopted an amendment to regulation 50.4(a) that expanded the existing clearing requirement for interest rate swaps pursuant to Section 2(h) of the Commodity Exchange Act. The amendment expanded existing regulations by (1) adding fixed-to floating interest rate swaps denominated in nine additional currencies, (2) adding basis swaps denominated in Australian dollar, (3) adding forward rate agreements denominated in four of those additional currencies, (4) adding overnight index swaps denominated in Australian dollar and Canadian dollar, and (5) changing the maximum stated determination date for overnight index swaps denominated in U.S. dollar, euro, and sterling from two to three years. [519.128a]

Inter-Affiliate Clearing Exemption

In April 2013, the CFTC adopted a final rule providing an exemption for inter-affiliate swap clearing [519.129] and the staff issued a no-action letter [519.130] providing limited relief for inter-affiliate swap reporting. Both sets of relief are subject to significant conditions that may limit their utility for many swap counterparties. The inter-affiliate clearing exemption provides a rule-based exemption from the clearing of swaps designated by the CFTC as subject to mandatory clearing between qualifying affiliates. The exemption is subject to several conditions, including qualifications applicable to the affiliated counterparties and documentation, risk management and reporting requirements.

The CFTC Division of Market Oversight issued a no-action letter providing relief from the trade execution requirement to eligible affiliate counterparties, as defined in the inter-affiliate clearing exemption, that do not satisfy the conditions of the inter-affiliate clearing exemption. [519.130a] In November 2014, the Division issued a no-action letter extending the relief to December 31, 2015. [519.130b] Subsequently, in November 2016, the Division issued further no-action relief until December 31, 2017. [519.130c]

To qualify for the exemption, affiliates must clear all of their swaps subject to mandatory clearing with unaffiliated counterparties at certain recognized clearinghouses or satisfy an exception from clearing under U.S. law or an exemption under foreign law deemed comparable by the CFTC and clear all designated swaps between “eligible affiliate counterparties” that have a “majority ownership” relationship. Such a relationship exists where: (i) one counterparty is, directly or indirectly, a majority owner of the other; or (ii) a third party is, directly or indirectly, a majority owner of both affiliate counterparties. The affiliates also must meet a consolidated financial statement requirement. Inter-affiliate designated swaps must be documented in writing, a requirement that will be met by a swap dealer or major swap participant satisfying its swap trading relationship documentation requirements. [519.131] Further, the inter-affiliate swap must be subject to a centralized risk management program that is reasonably designed to monitor and manage the risks associated with the swap. [519.132] Additionally, the affiliates must report specified information to a swap data repository on either a swap-by-swap basis or annually. [519.133] To provide for an orderly transition period, and in response to concerns about timing of non-U.S. jurisdictions' implementation of mandatory clearing regimes, the Commission provided temporary, alternative means to meet these requirements. [519.133a]

Following successive extensions of the temporary alternative relief, in June 2020, the CFTC approved amendments to Rule 50.52, the conditional inter-affiliate exemption, to make the alternative compliance frameworks permanent. [519.133b] As amended, Rule 50.52 will codify an alternative means of compliance, based upon, among other things, the exchange of full, daily variation margin, for inter-affiliate swaps that are not subject to a foreign clearing regime that the CFTC has found to be comparable.

Cooperative Clearing Exemption

In August 2013, the CFTC issued a final rule to exempt swaps entered into by qualified cooperatives from the mandatory clearing requirement, subject to certain conditions. [519.134] In order to elect not to clear a swap subject to the clearing requirement, the cooperative's members must be either non-financial entities or cooperatives whose members are non-financial entities. In addition, the swap must be entered into in connection with originating loans to cooperative members or to hedge or mitigate commercial risk related to loans to, or swaps with, members. Similar to the information required to be reported under the end-user exception and inter-affiliate exemption, the reporting counterparty would be required to report the election of the cooperative exemption, as well as certain other information, to a swap data repository (or, if no swap data repository is available, to the CFTC).

Clearing Documentation, Timing and Risk Management Rules

In March 2012, the CFTC finalized a package of rules relating to swap clearing. The three overarching themes addressed are: (i) non-discriminatory access to counterparties and clearing; (ii) straight-through processing; and (iii) effective risk management by clearing members. [519.135] These rules included controversial limitations on the arrangements that clearing members and derivatives clearing organizations (DCOs) may have with respect to clearing customers. Most importantly, these rules would prohibit tri-party agreements in which a futures commission merchant (FCM) clearing member could limit the number or size of swaps with a specific executing swap dealer that the clearing member would clear for a customer. This appears to have been motivated by publication of a template annex for tri-party arrangements that had been developed by industry groups for optional use in negotiating execution-related documentation between swap dealers and their customers. The CFTC was concerned that by giving FCMs the ability to set sub-limits on the positions a customer can clear with a specific swap dealer, FCMs could influence the amount of swap activity a customer could transact with specific counterparties, including swap dealers affiliated with that FCM. In addition, communicating reductions in such “sub-limits” during times of market stress could signal false information regarding counterparty credit, making it more difficult for counterparties to trade.

Specifically, the final rules prohibit DCOs, FCMs providing clearing services to customers of swap dealers and major swap participants from entering into an arrangement that would:

- disclose to the FCM or any swap dealer or major swap participant the identity of a customer's original executing counterparty;
- limit the number of counterparties with whom a customer may enter into a trade;
- restrict the size of the position a customer may take with any individual counterparty, apart from an overall limit for all positions held by the customer at the FCM or with the swap dealer or major swap participant;
- impair a customer's access to execution of a trade on terms that have a reasonable relationship to the best available terms; or
- prevent compliance with required time frames for acceptance of trades into clearing.

The CFTC notes that these provisions are only meant to govern execution with third parties and do not prohibit swap dealers and major swap participants from establishing their own trading limits with individual counterparties. In addition, the CFTC stated that swap dealers and major swap participants may require that a counterparty confirm that it has an account with an FCM through which the counterparty will clear.

The rules establish both timing and other requirements for swap dealers and major swap participants to submit swaps not executed on a swap execution facility or designated contract market (“off-facility swaps”) for clearing on a DCO. Swap dealers and major swap participants must ensure that they have the capacity to route off-facility swaps to a DCO in a manner acceptable to the DCO and must coordinate with the DCO to facilitate “prompt and efficient” trade processing. This provision is general enough to allow DCOs to permit routing of off-facility swaps directly to the DCO or through third-party platforms and to determine the role of clearing members in the process. The rules require off-facility swaps required to be cleared to be submitted to the DCO as soon as technologically practicable after execution but no later than by the close of business on the date of execution. In contrast, off-facility swaps that are not required to be cleared, but are cleared by election of the parties, must be submitted no later than the business day after execution of the swap or, if later, the agreement to clear. "Business day" is not defined in order to allow flexibility for market participants.

While there is no explicit timing requirement for the submission for clearing of swaps executed on a designated contract market or swap execution facility ("on-facility swaps"), several interconnected rules applicable to swap execution facilities, designated contract markets and DCOs establish a framework for the "prompt, efficient and accurate processing" of such transactions for clearing. The rules require that transactions executed on or through a designated contract market (other than security futures) must be cleared on a DCO, and that the designated contract market must work with the DCO to ensure "prompt and efficient" transaction processing so that the DCO can comply with its own requirements for prompt transaction processing. Similarly, the rules require swap execution facilities to coordinate with DCOs to route transactions in a manner acceptable to the DCO and to develop rules and procedures to comply with the prompt transaction processing requirements.

The rules also require clearing members and DCOs to accept or reject contracts for clearing "as quickly as would be technologically practicable if fully automated systems were used." While the CFTC explains that this standard is intended to approximate real-time acceptance, within milliseconds, seconds or (at most) a few minutes, it is unclear how a manual process could ever operate at the same speed as a fully automated system. Clearing members may satisfy this requirement by establishing systems: (i) to pre-screen orders for compliance with criteria specified by the clearing member; (ii) to authorize a DCO to accept or reject on its behalf trades that meet, or fail to meet, criteria specified by the clearing member; or (iii) to enable the clearing member to communicate to the DCO acceptance or rejection of each trade as quickly as would be technologically practicable if fully automated systems were used. A DCO must accept all trades for which: (i) executing parties have clearing arrangements in place with clearing members of the DCO; (ii) executing parties identify the DCO as the intended clearing house; (iii) the swap satisfies the non-discriminatory criteria (with respect to trading venue and clearing participant) of the DCO; and (iv) in the case of an off-facility swap, the specific submission timing requirements are met.

The CFTC stopped short of requiring DCOs to accept or reject swaps executed on a designated contract market or swap execution facility immediately, noting that the rule was intended to strike a balance between the CFTC's belief that acceptance or rejection for clearing as close to real time as possible is crucial to risk management and efficiency, and the DCO's need to evaluate and aggregate the risk of incoming trades to determine whether trading or credit limits for a clearing member or customer are not exceeded. The CFTC has delegated to its staff the ability to establish an alternative compliance schedule to comply with clearing acceptance provisions that are "technologically or economically impracticable."

The new rules permit post-execution allocation of swap transactions executed as a block ("bunched orders"). Allocation must occur as soon as practicable after the transaction is executed but, for cleared trades, no later than a time sufficiently before the end of the day the order is executed to ensure that clearing records identify the ultimate customer for each trade. Allocation for uncleared trades must occur no later than the end of the calendar day on which the swap is executed.

In order to limit the risks posed by and to clearing members by customer clearing, the rules require each clearing member to: [519.136] (i) establish risk-based limits for its proprietary account and, for FCMs, for its customer accounts, based on position size, order size, margin requirements or similar factors; (ii) screen orders to ensure compliance with risk-based limits (including for FCM clearing members, in the case of "give-ups," screening by the clearing FCM to set limits for the customer and entering into an agreement in advance with the executing firm requiring the executing firm to screen orders for compliance with those limits and, in the case of bunched orders, screening by both the FCM who clears the block and the FCMs that clear the allocated trades); (iii) monitor for adherence to the risk-based limits intra-day and overnight; (iv) conduct stress tests, under extreme but plausible conditions, of all positions in each account that could pose material risks to the clearing member at least weekly; (v) evaluate its ability to meet initial margin requirements at least weekly; (vi) evaluate its ability to meet variation margin requirements in cash at least weekly; (vii) evaluate its ability to liquidate positions it clears in an orderly manner and estimate the cost of liquidation, which is required quarterly for FCMs; and (viii) test all lines of credit at least annually.

Clearing members are required to establish written policies to comply with the risk management rules and to keep full, complete and systematic records. These records must be available to the CFTC and relevant prudential regulators promptly upon request. In providing general requirements for clearing member risk management rather than detailed procedures, the CFTC has "intentionally drafted [the rules] in a non-prescriptive manner" in order to allow firms to make judgment calls based on their own risk profile, including customer base, resources and risk appetite. [519.137]

Treasury Affiliates

The CFTC's Division of Clearing and Risk granted limited no-action relief from the mandatory clearing requirement for swaps entered into by certain treasury affiliates within non-financial corporate groups. [519.138] The relief permits eligible treasury affiliates that are not otherwise eligible for the end-user exception to continue to enter into non-cleared hedging transactions for the benefit of their non-financial affiliates, but is subject to several substantial conditions and limitations.

[12B] Retail Foreign Currency and Commodity Transactions

As amended by the Dodd-Frank Act, the CEA now provides distinct treatment for retail foreign exchange transactions and retail commodity transactions. [519.139] These new provisions address the CFTC's long-standing concerns about fraudulent conduct in over-the-counter transactions involving retail public customers. Prosecution of fraudulent conduct involving over-the-counter forex contracts had historically been a major enforcement problem for the CFTC because these transactions could be prosecuted by the CFTC only by establishing that they constituted illegal futures contracts—then the only jurisdictional predicate for CFTC enforcement actions. The 2008 amendments to the CEA relating to retail foreign exchange contracts provided the foundation for the more robust, comprehensive approach evident in Dodd-Frank's treatment of retail foreign currency transactions. The 2008 amendments broke important new ground by extending CFTC antifraud and regulatory jurisdiction to foreign currency transactions offered to persons who do not qualify as eligible contract participants, regardless of how those transactions might be classified legally, provided that they were offered or entered into on a leveraged, margined or financed basis and were not settled by delivery within two days. Unless such transactions were offered by a CFTC-registered futures commission merchant (or associated person thereof), a financial institution, a securities broker-dealer registered under the Securities Exchange Act of 1934 (or an associated person thereof) or a registered retail foreign exchange dealer, they would be required to be conducted in accordance with rules adopted by the CFTC.

The Dodd-Frank Act expands upon this foundation to require that transactions in retail foreign currency by financial institutions and SEC-registered broker-dealers be undertaken in compliance with the relevant regulatory agency's rules for such transactions. These rules are required to prescribe appropriate requirements with respect to disclosure, recordkeeping, capital and margin, reporting, business conduct, documentation and "such other standards and requirements as the Federal regulatory agency shall determine to be necessary." [519.140] Persons, other than broker-dealers (and their associated persons), U.S. financial institutions, CFTC-registered retail foreign exchange dealers or financial holding companies soliciting or accepting orders from non-ECPs for retail forex transactions, exercising discretionary trading authority or operating pooled investment vehicles involving retail forex transactions are required to register in an appropriate capacity as determined by the CFTC.

The Dodd-Frank amendments with respect to retail commodity transactions directly target the *Zelener* decision and essentially render such transactions illegal, unless they fall within specified exceptions. [519.141] Retail commodity transactions are defined as transactions entered into or offered to a person that is not an eligible contract participant or eligible commercial entity and entered into or offered "on a leveraged or margined basis, or financed by the offeror, the counterparty, or a person acting in concert with the offeror or counterparty on a similar basis." Statutory exclusions from these provisions are provided for: retail foreign currency transactions, transactions in securities, identified bank products, and a contract of sale that "results in actual delivery within 28 days or such other longer period as the Commission may determine by rule or regulation based upon the typical commercial practice in cash or spot markets for the commodity involved; or creates an enforceable obligation to deliver between a seller and a buyer that have the ability to deliver and accept delivery, respectively, in connection with the line of business of the seller and buyer."

Retail commodity transactions that are not excluded from the statutory definition are effectively rendered illegal because they are made subject to section 4(a) of the Act, as well as antifraud prohibitions, "as if the agreement, contract, or transaction was a contract of sale of a commodity for future delivery." Section 4(a) codifies the exchange trading requirement for futures contracts, rendering it unlawful to enter into or offer to enter into a contract for the purchase or sale of a commodity for future delivery (other than a foreign futures contract) unless the transaction is conducted on a contract market designated by the CFTC. Retail commodity transactions are thus deemed to be illegal off-exchange futures contracts unless they qualify for one of the statutory exclusions.

Transactions that are settled by actual delivery within 28 days are excluded from the retail commodity transaction provision. The CFTC has adopted an interpretation, following notice and comment, addressing the "actual delivery" requirement of the exclusion for contracts resulting in actual delivery within 28 days. [519.142] As discussed therein, the Commission will adhere to a functional approach and "examine how the agreement, contract, or transaction is marketed, managed, and performed, instead of relying solely on language used by the parties in the agreement, contract or transaction." [519.143]

The Commission's subsequent application of its interpretation of the term "actual delivery" in litigated and settled cases has spawned controversy and has not resulted in a clear standard. The Eleventh Circuit in *CFTC v. Hunter Wise Commodities, LLC* [519.144] opined that the term "actual delivery" is unambiguous and should be given its ordinary meaning. Accordingly, the court did not rely on the Commission's interpretation, although it found that it complements the court's own. [519.145] The court, relying on a definition in *Black's Law Dictionary*, declared that "delivery" is "[t]he formal act of transferring something"; it denotes a transfer of possession and control." [519.146] As such, "'[a]ctual delivery" denotes '[t]he act of giving real and immediate possession to the buyer or the buyer's agent.'" [519.147] The court explained that "[a]ctual delivery" is distinct from "constructive delivery" in that "actual" is that which "exist[s] in fact" and is "real," rather than constructive. [519.148]

Hunter Wise Commodities, LLC was a precious metals dealer that sold metal to retail customers on a financed or leveraged basis. Pursuant to the terms of their financings, customers were not entitled to take personal possession of the metal until they fully repaid the loan they received in purchasing it. The court upheld the district's court's finding that Hunter Wise failed to satisfy the "actual delivery" requirement for its financed sales to customers because Hunter Wise itself did not have title or control of the metal it committed to deliver and therefore it had no metal with which actual delivery could have been made. In this regard, the court found that the vast majority of the metal Hunter Wise had purchased to cover its sales to customers had been purchased from other dealers on a financed basis, and Hunter Wise had no right to take control of it and had never received title to it. [519.149]

In many subsequent cases against other precious metals dealers, the Commission has embraced the *Hunter Wise* interpretation, finding it to be consistent with its own and generally taking the position that any financed sales of precious metals to retail customers do not result in actual delivery where a customer may not take possession of the physical metal until the customer pays in full, even where the precious metal is held in a third-party depository. This aggressive interpretation caused it to abandon the interpretation of the term it originally had advocated in *CFTC v. Worth Group, Inc*. [519.150] In that case, filed in August 2013, the Commission sued to enjoin the defendants' sale of precious metals on a number of grounds, including fraud. The court appointed a Corporate Monitor to evaluate, among other things, Worth's current procedures and practices for actual delivery of precious metals to its retail customers. The Monitor concluded that ongoing sales were permissible in part because the actual physical metal sold to the customer was held in a depository in an account in the customer's name. [519.151] This conclusion seemed to be consistent with the Commission's position on the interpretation of "actual delivery" taken at the outset of the case.

Following the decision in *Hunter Wise*, however, the Commission sought to amend its complaint in *CFTC v. Worth Group, Inc.* in order to apply a different interpretation of "actual delivery" that would disqualify the Worth Group's financed sales from satisfying the elements of "actual delivery." The district court denied the Commission's motion to amend its complaint not only on grounds of untimeliness and prejudice to the defendants, but also because the Commission's new interpretation, if applied, would "violate Defendants' constitutional rights to fair notice and would therefore be subject to dismissal." [519.152] The court pointedly rejected the Commission's interpretive inconsistency:

> The proposed amendment would violate the Defendants' constitutional rights to fair notice under Supreme Court precedent and would therefore be subject to dismissal. Defendants raised this issue —that if the CFTC was seeking to impose penalties based on Worth's delivery method, it would violate Worth's due process rights—at the initiation of this proceeding. *See* Motion to Dismiss [DE 43], at 15–19. Plaintiff [the CFTC] assured this Court there was no due process violation, going so far as to title one [of] its sections in its response to the [Defendants' original] motion to dismiss "There is No Dispute in this Case Regarding the Meaning of 'Actual Delivery'" and explaining in the filing that there was nothing "violative with Worth's practice of making 'actual delivery' by physically delivering metal to a depository and allocating it into an account held in the customer's name." *See* Plaintiff's Response in Opposition to Defendants' Motion to Dismiss [DE 48], at 16. Based on this assertion, the Court agreed with Plaintiff, noting there is no due process violation because "[t]he Complaint does not subject Defendants to possible penalties related to Worth's delivery methodology.…" *See* Order on the Motion to Dismiss [DE 79], at 19 (citing *Rochling v. Dep't of Veterans Affairs*, 725 F.3d 927, 931 (8th Cir. 2013) (deeming due process claim insufficient because the claim of injury did not rise above "speculative level")). Even the Monitor assumed that Worth's delivery process constituted "actual delivery." *See* [DE 120] at 4, n.2 (emphasis added). Using the CFTC Administrative Interpretation as guidance, the Monitor confirmed that Worth's delivery process, when completed within 28 days, constituted "actual delivery." *Id.* at 3.
>
> Plaintiff has now reversed its position with regard to the delivery issue without any notice to Defendants—indeed after assuring Defendants and the Court of the opposite—and seeks to impose penalties on Worth for their delivery process. "Fair warning" is provided "[i]f, by reviewing the regulations and other public statements issued by the agency, a regulated party acting in good faith would be able to identify, with 'ascertainable certainty', the standards with which the agency expects parties to conform." *See Howmet Corp v. E.P.A.,* 614 F.3d 544, 553-54 (D.C.Cir.2010) (quoting *Gen. Elec. Co. v. E.P.A.,* 53 F.3d 1324, 1329 (D.C.Cir.1995)). Where Plaintiff itself concedes that it is changing its own prior interpretation of a statute based on its interpretation of a recent court opinion, it certainly cannot claim that the Defendants had "fair notice" that its conduct would be considered by Plaintiff to be illegal under that statute. [519.153]

The Commission's interpretation was challenged again in *Commodity Futures Trading Commission v. Monex Deposit Co.*, [519.154] a subpoena enforcement action where the investigated precious metals dealer sought to stop a Commission investigation on grounds it was outside the Commission's jurisdiction. Monex Deposit Company sought to factually distinguish its sales from those described in *Hunter Wise* on the basis that in Monex's financed sales the precious metal covering the sale is held in a depository until the customer makes full payment. [519.155] Judge Easterbrook, writing for a panel of the Seventh Circuit Court of Appeals, rejected the attack on the Commission's jurisdiction as premature at the investigation stage, but nicely framed the legal interpretive debate between the parties:

> If Monex lacks enough inventory to deliver on all of its contracts, it may be acting more like a bank in a system of fractional-reserve banking (as the Federal Reserve did in the days when the United States adhered to the gold standard but lacked enough gold to pay off every bit of paper currency). Monex tells us that it has on hand metals enough to fulfill all contracts, and that its customers always take delivery (at least in the sense that metals are transferred to a depository until the full price is paid). If so, Monex may prevail in any enforcement action. But it has not given a good reason why the CFTC is forbidden even to gather the facts that will show whether the exception applies. [519.156]

In 2017, the CFTC commenced an enforcement action against Monex alleging that in connection with its financed sales and purchases of precious metals with retail customers it (1) violated CEA Sections 4(a) and 4d by failing to register as an FCM, and (2) engaged in fraud in violation of CEA Sections §4b(a)(2)(A) and 6(c)(1) and CFTC Rule 180.1. In May 2018, the court dismissed the suit for failure to state a claim. [519.156a] The court dismissed the Section 4(a), 4b and 4d claims because the alleged transactions satisfied the “actual delivery” exemption from the application of those Sections. [519.156b] The court found that the fact that there was no dispute that Monex delivered sufficient precious metal to independent depositories for the benefit of customers within 28 days to cover the customers' transaction satisfied the actual delivery exception to the CFTC's authority. [519.156c] The court distinguished Monex's alleged transactions from those in *Hunter Wise* where depositories held insufficient metal to cover their sales to customers.

This holding rejected the CFTC's arguments that the actual delivery exemption has not been satisfied because customers lacked control over or possession of the metal since the metal allegedly was stored at depositories in accounts in Monex's name that it controlled, the metal at the depositories remained collateral for Monex's lien against it, Monex had discretion to liquidate customer positions at any time, and thousands of accounts had been subject to margin calls and/or forced liquidations in the prior six years. [519.156d] The court in this regard concluded that Congress could not have intended that such commercial rights would negate actual delivery because the underlying premise for the statute's retail commodities provision was that transactions would be leveraged or financed. The court could not conceive of any “plausible leveraged retail transaction of fungible commodities that would not involve at least some of the same alleged practices.” [519.156e] The court also relied on the legislative history of CEA Section 2(c)(2)(D), finding that an early version of the provision excluded from the definition of actual delivery any “delivery to a third party in a financed transaction in which the commodity is held as collateral.” [519.156f] The court concluded that the removal of this exclusion from the definition showed an intent that holding a commodity in a third party depository as collateral would not prevent a finding of “actual delivery.” [519.156g]

In July 2019, the U.S Court of Appeals for the Ninth Circuit reversed the district court's decision, reinstating the CFTC's claims. The Ninth Circuit opined that “at least some meaningful degree of possession or control by the customer” is required to meet the actual delivery exception. [519.157] The court concluded that: “It is possible for this exception to be satisfied when the commodity sits in a third-party depository, but not when, as here, metals are in the broker's chosen depository, never exchange hands, and are subject to the broker's exclusive control, and customers have no substantial, non-contingent interests.” [519.158] Based on that finding, the court found that the CFTC also could enforce CEA Section 4 and in particular the antifraud provision Section 4b. [519.159] This decision is further discussed in §5.05[3].

In June 2016, the Commission applied the Retail Commodity Transaction provision in section 2(c)(2)(D) of the Act to the world of blockchain transactions and trading in cryptocurrency in *In the Matter of BFXNA Inc., d/b/*

a Bitfitnex, CFTC Docket No. 16-19 (June 2, 2016) (“ *Bitfinex*”). [519.160] The Commission's settlement order sanctioned a Hong Kong company, Bitfinex, for operating, without proper registration under the CEA, a platform for retail users to lend and trade bitcoin and other cryptocurrencies on margin among each other. [519.161] The Commission found that the transactions failed to result in “actual delivery” of the currencies to the borrowers or buyers in order to qualify for exemption from the Act.

Within the blockchain infrastructure, cryptocurrencies (or any property) can be transferred between different “deposit wallets” on the blockchain, each of which is a separate address and has a separate code (“private keys”) required to access it. Property also can be transferred within a single wallet. In this regard, multiple persons can set up personal accounts with the holder of a single wallet, each deposit currency to his, her, or its account, and, if they choose to, transfer currencies between and among their separate accounts within the single wallet. The Commission's description of the Bitfinex platform indicates that it maintained a deposit wallet in which users would establish private accounts for holding their personally owned currency and would trade or lend their currencies among themselves by transferring it between or among their separately denominated accounts.

The Commission's describes Bitfinex's three different iterations of this:

> From April 2013 to August 2015, when a customer purchased bitcoins on Bitfinex, the purchased bitcoins were held for the benefit of the buyer in Bitfinex's omnibus settlement wallet. The individual customer interests in the omnibus settlement wallet were accounted for in real time on Bitfinex's database. However, the omnibus settlement wallet was owned and controlled by Bitfinex and Bitfinex held all “private keys” associated with its omnibus settlement wallet. Financing Recipients had no rights to access or use the bitcoins that they had purchased until Bitfinex released them, following satisfaction of the Financing Recipient's outstanding loan. Bitfinex considered bitcoins held in the omnibus wallet to belong to the Financing Recipients, but subject to a lien in the amount of any outstanding loan plus fees owed to the Margin Funding Provider.
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> In August 2015, Bitfinex changed its model so that bitcoins purchased using the Exchange Trading feature were held in multi-signature wallets established by a third party firm that were individually enumerated for each trader. Bitcoins purchased using the Exchange Trading feature were settled to the Blockchain on an intra-day basis. However, Bitfinex retained control over the private keys to these wallets as well.
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> In January 2016 and for the remainder of the Relevant Period, during the course of the Division of Enforcement's investigation, Bitfinex changed its model again so that bitcoins purchased using both the Exchange Trading and Margin Trading features were held in individually enumerated, multi-signature wallets. However, Bitfinex continued to retain control over the private keys to those wallets. [519.162]

The order does not state what transactional element(s) must occur for a transfer to result in “actual delivery.” However, based on the foregoing description of Bitfinex transactions deemed by the Commission not to result in actual delivery, the order appears to suggest that any one of a number of variables might be essential. These include perhaps requiring a transfer of currency to a customer's private wallet separate from the Bitfinex wallet, or perhaps the customer must have some control over the private keys for the Bitfinex wallet, or there can be no restriction on withdrawing borrowed currency from the platform even when the customer's loan received from another customer has not been satisfied. Each of these would have implications for the development of the cryptocurrency market and, potentially, the use of blockchain for transferring ownership of any property. It appears to treat operational aspects of property transfer as determinative of the transfer of ownership and legal control of property to the denigration of the terms of the contracts and agreements between parties themselves. In this connection, it appears from the Commission's description of margin transactions on the Bitfinex platform that the parties' contracts and agreements seemed to recognize that the receipt of currency into a customer's account on Bitfinex pursuant to a loan or margined trade constituted the transfer of ownership of the currency to the recipient. Since cryptocurrency has only a virtual, non-physical existence, there is no place it can be recognized or held other than in an account. The *Bitfinex* order, while not clear, might imply that actual delivery will be recognized only if cryptocurrency is received or, perhaps, can be received, into a particular type of wallet, even if the parties' agreements would not impose such a condition for ownership and legal control over the currency to transfer to the recipient. The settlement order provides no rationale for why the Act would require such a condition.

[12C] Cryptocurrency

In 2017 and 2018, the CFTC and SEC intensified their attention to the regulation of the different types of digital assets designed to be recorded and transferred via blockchain technology. Those asset types go by various names, including cryptocurrencies, "virtual" currencies, coins, tokens, and "digitized" assets. Currently, there is no uniform legal or commercial definition for these terms. Various functional differences, however, can include, among others, use as a medium of exchange that does not constitute legal tender or government-backed "fiat" currency, [519.160] as securities to invest in a for-profit enterprise, [519.161] as a unit of account, [519.162] as a store of value such as the value like gold or other hard commodity. [519.163] A digitized asset may also underlie a derivatives contract, and the derivative contract itself may also be traded in a digitized form. [519.164] Their common denominator, nevertheless, is that each is a digital representation of value that does not have a physical presence; each is simply code that is designed to be recordable and transferable on a blockchain. At the time of this writing, there are reported to be over 1500 virtual coins and tokens in existence. Except where otherwise noted, this treatise will use the various digital asset names interchangeably without intending to distinguish one from another.

The CFTC first declared jurisdiction over transactions in virtual currencies in its 2015 settlement order in *In re Coinflip, Inc.*, by declaring that bitcoin and, by implication, other cryptocurrencies are commodities. That finding was a predicate to the CFTC's determination that the respondent's platform for trading options on bitcoin required compliance with the CFTC's rules for trading options and registration as a swap execution facility ("SEF") or designated contract market ("DCM"). [519.165] The Commission's June 2016 settlement order in *In re BFXNA Inc., d/b/a Bitfinex* reiterated its position that cryptocurrencies are commodities, finding that leveraged transactions in cryptocurrency between non-eligible contract participants that did not result in "actual delivery" were subject to the CEA's retail commodity transactions provision. [519.166] The CFTC also has made clear that, while it has full regulatory and enforcement jurisdiction over derivatives and retail commodity transactions on virtual currencies, its jurisdiction over non-leveraged spot or forward transactions in cryptocurrency is limited to its enforcement authority to deter and impose sanctions for fraud and manipulation. [519.167] In March 2018, the federal district court in *CFTC v. McDonnell* [519.168] in denying a motion to dismiss held that cryptocurrencies are "'goods' exchanged in a market for a uniform quality and value" and "fall well-within" the common definition of commodity as well as the CEA's broad definition. Notably, the court expressly found that the CEA definition of "commodity" extended to transactions that did not involve futures or derivatives contracts. [519.169] The court also held that the alleged fraudulent activities relating to the offer and sale of spot transactions in cryptocurrencies were within the scope of the antifraud provisions of CEA Section 6(c)(1) and CFTC Rule 180.1(a). In August 2018, following a bench trial, the court found defendants liable for violation of Rule 180.1, ordered payment of restitution and a penalty, imposed permanent trading and registration bans on defendants, and permanently enjoined them from further violations of the CEA and CFTC regulations, as charged. [519.169a]

In September 2018, the federal district court in *CFTC v. My Big Coin Pay, Inc.* in denying a motion to dismiss held that the cryptocurrency offered by the defendant was a commodity under the CEA, even though no derivative was traded on it. [519.169b] The court held that it was sufficient for the pleadings stage to conclude that My Big Coin was a commodity on the basis that there are futures contracts traded on **b**itcoin and that My Big

Coin, and by implication other cryptocurrencies, can be deemed to be simply different "classes" of the same commodity. [519.169c]

The CFTC has commenced and successfully prosecuted other enforcement actions for fraud and manipulation involving off-exchange options, forward transactions, and spot transactions on virtual currencies. [519.170]

CFTC-authorized derivatives trading on cryptocurrency began in 2017. In July 2017, the CFTC granted LedgerX, LLC ("LedgerX") permission to register as a SEF and as a derivatives clearing organization ("DCO") for bitcoin-based swaps, making LedgerX the first CFTC-approved bitcoin options trading platform and clearinghouse. [519.171] On December 1, 2017, the Chicago Mercantile Exchange Inc. ("CME") and the CBOE Futures Exchange ("CFE") self-certified new contracts for bitcoin futures products, and the Cantor Exchange self-certified a new contract for bitcoin binary options. [519.172]

In March 2020, the CFTC Commissioners unanimously approved final interpretative guidance of the term "actual delivery" that is specifically applicable to retail commodity transactions in virtual currency, largely adopting an interpretation it had proposed in 2017. [519.173] In the final guidance, the CFTC interprets virtual currency broadly as a digital asset "that encompasses any digital representation of value or unit of account that is or can be used as a form of currency (*i.e.*, transferred from one party to another as a medium of exchange); may be manifested through units, tokens, or coins, among other things; and may be distributed by way of digital 'smart contracts,' among other structures." [519.174]

The CFTC's interpretation declares that "actual delivery" occurs within the context of virtual currency when:

(1) A customer no later than 28 days from the date of the transaction has the ability to: (i) take possession and control of the entire quantity of the commodity, whether it was purchased on margin, or using leverage, or any other financing arrangement, and (ii) use it freely in commerce (both within and away from any particular platform); *and*

(2) At the expiration of 28 days from the date of the transaction, the offeror and counterparty seller (including any of their respective affiliates or other persons acting in concert with the offeror or counterparty seller on a similar basis) does not retain any interest in or control over any of the commodity purchased on margin, leverage, or other financing arrangement. [519.175]

The final interpretation further provides that actual delivery requires physical settlement to occur, *i.e*., the transfer of the digital asset must be recorded from the account of the seller to the account of the buyer within 28 days of the transaction. Notably, the final interpretation allows that actual delivery may occur even when the offeror has some affiliation with a legally distinct depository, "so long as there are certain safeguards to ensure that the customer receives actual possession and control over the purchased commodity within the 28-day actual delivery period." [519.176] The SEC has asserted jurisdiction over virtual currencies and tokens that are securities or are offered or traded in connection with securities transactions. The SEC and CFTC intend to work together in policing the markets. [519.177] The SEC's actions have included guidance on when a virtual currency will be deemed to be a security, the application of securities registration requirements to initial coin offerings ("ICOs"), commencement of enforcement actions based on fraud and lack of securities registration, and disapproval of an exchange-traded fund on bitcoin. It remains to be seen how the agencies will implement their respective jurisdictions. Resolution of jurisdictional issues can be difficult because, given the sometimes subtle nuances in the legal definitions of a security and commodity forwards, futures, and swaps, there may be circumstances where it will not be clear whether a virtual currency transaction involves a security or a CFTC-regulated transaction. The SEC to date has not delineated any clear safe harbors or definitions, but rather, has indicated the issue will be resolved on a case-by-case analysis of the facts. [519.178] In March 2017, the SEC rejected an application for a bitcoin-based ETF based on the fact that the market for the underlying commodity (bitcoin) was unregulated. [519.179] Like the CFTC, the SEC has commenced a number of enforcement actions for fraud in connection with the sale of virtual currencies and tokens that the agency alleges took the form of securities. [519.180]

In April 2019, the SEC staff provided additional and more comprehensive guidance on the application of the *Howey* test to digital assets in its *Framework for "Investment Contract" Analysis of Digital Assets* ("Framework") [519.181] and a no-action letter to TurnKey Jet, Inc. (the "TurnKey No-Action Letter"). [519.182] The Framework organizes the staff's prior guidance in the 2017 Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017) [519.183] and the June 2018 speech of William Hinman, Director of the SEC's Division of Corporate Finance (the "Hinman Speech") [519.184] on when digital assets are securities, in the context of each element of the *Howey* test, and elaborates on when decentralization of a digital network may take a token outside the *Howey* test.

The Framework principally addresses the third and fourth prongs of the *Howey* test -- whether there is "a reasonable expectation of profits" from an enterprise and whether the profits "derive from the efforts of others." [519.185] The Framework ties those prongs to whether an "Active Participant" ("AP"), such as a promotor, sponsor or other third party (or affiliated group of third parties), has a "central role" in providing essential managerial efforts affecting the success of the enterprise. The Framework provides many examples of characteristics of digital assets that can bear on how they fare under the *Howey* test, including, among many others, whether:

- The digital asset's creation and structure is designed and implemented to meet the needs of its users, rather than to feed speculation as to its value or development of its network;
- Prospects for appreciation in the value of the digital asset are limited;
- The digital asset is transferrable to third parties or traded in a secondary market or likely to be so in the future;
- There is little apparent correlation between quantities the digital asset typically trades in (or the amounts that purchasers typically purchase) and the amount of the underlying goods or services a typical consumer would purchase for use or consumption;
- The AP has raised an amount of funds in excess of what may be needed to establish a functional network or digital asset;
- The AP is able to benefit as a result of holding the digital asset;
- The AP distributes the digital asset as compensation to management or the AP's compensation is tied to the price of the digital asset in the secondary market; and
- The AP monetizes the value of the digital asset, especially where the digital asset has limited functionality.

The Framework also explains that whether a digital asset previously sold as a security should be reevaluated and considered not to be a security at the time of later offers or sales can turn on:

- Whether or not the efforts of an AP, including any successor AP, continue to be important to the value of an investment in the digital asset;
- Whether the network on which the digital asset is to function operates in such a manner that purchasers would no longer reasonably expect an AP to carry out essential managerial or entrepreneurial efforts; and
- Whether the efforts of an AP are no longer affecting the enterprise's success.

The TurnKey Jet No-Action Letter addressed a company's token that was designed to be a dollar-denominated stablecoin that would allow users of air travel services to pay for the services without the various transaction costs and delays associated with credit card and wire transfers. The letter provided that the SEC Division of Corporate Finance will not recommend enforcement action to the SEC if, in the issuer's reliance on counsel's legal opinion that the tokens are not securities, the issuer offers and sells the tokens without registration under the Securities Act and the Exchange Act. The No-Action Letter states that particularly noteworthy reasons for the relief were:

- The issuer will not use any funds from the token sales to develop the issuer's platform, network, or app, and each of these will be fully developed and operational at the time any tokens are sold;
- The tokens will be immediately usable for their intended functionality (purchasing air charter services) at the time they are sold;
- The issuer will restrict transfers of tokens to the issuer's digital wallet only, and not to wallets external to the platform;
- The issuer will sell tokens at a price of one USD per token throughout the life of the program, and each token will represent the issuer's obligation to supply air charter services at a value of one USD per token;
- If the issuer offers to repurchase tokens, it will only do so at a discount to the face value of the tokens (one USD per token) that the holder seeks to resell to the issuer, unless a court within the United States orders the issuer to liquidate the tokens; and
- The token is marketed in a manner that emphasizes the functionality of the token, and not the potential for the increase in the market value of the token.

It bears emphases that the nominal asset underlying the TurnKey Jet tokens is the U.S. dollar. Were the underlying, for example, a physical commodity or company product or service, that potentially could introduce speculative or investment opportunities that might implicate the *Howey* test and the application of the CEA. [519.186]

Many of the developments discussed in this Section as well as many others, including international regulatory regimes for digital assets, are analyzed in an American Bar Association White Paper entitled *Digital and Digitized Assets: Federal and State Jurisdictional Issues*. [519.187]

[13] Commodity Margins

The following discussion relates principally to the margin protocols used on the CFTC-regulated exchanges for futures and options on futures transactions. There are no standards with respect to deposits (if any) supporting transactions that are either excluded from the Act [520] or are exempted from the Act [521] due to the nature of the underlying commodities and parties, or for over-the-counter swaps. [522] Moreover, the discussion does not include the formal margin protocols for securities derivatives, including security options and securities futures products. [523] It is worth noting however, that as explained below, securities transactions that are done on margin involve the extension of credit whereas commodity margins are a totally different concept.

The term *margin* first came into usage in the financial world as shorthand for the minimum amount that a *securities* purchaser must deliver to his broker before title to the securities would pass to him. The remaining balance was borrowed (from the broker in most instances), and the buyer—now owner—of the securities would often deposit the certificates with the broker as a pledge against the unpaid balance. The securities margin, therefore, had two significant features: (1) the buyer was conveyed title to the securities immediately despite an unpaid balance; and (2) the broker (or other lender) extended credit to the new owner for the remainder of the purchase price. In the wake of the 1929 stock market crash, Congress lamented what it considered to have been excessive extensions of this type of credit to stock purchasers in earlier years and authorized the Board of Governors of the then-new Federal Reserve System to set regulations limiting the amount of money that could be loaned by a broker or dealer to a securities purchaser. [524]

Through a process that can only be described as unfortunate, the commodity industry has chosen to utilize the same term— *margin*—to signify a drastically different economic event. Futures trading occurs in *executory contracts* as yet uncompleted, representing an exchange of mutual promises to conclude a sale later on specific terms. Acquisition of a futures contract, therefore, leaves title and ownership of the underlying commodity exactly where it was before the contract was entered. Title will not pass unless and until the futures contract is fully performed by both parties: the seller by delivering what he has promised; the buyer by tendering the *full* purchase price.

At the same time, however, entry into a futures contract creates the risk that, when required, one of the parties may default on his obligation. The seller might fail to deliver the commodity as promised, or the buyer may fail to pay. For the protection of both, *each* party (seller as well as buyer) is required by clearinghouse rules to deposit with his broker a certain sum of money (or a qualified property equivalent) in the nature of a performance bond or earnest money. [524.1] This sum, inappropriately called a margin, is not recorded as a down payment or partial payment of the purchase price of the commodity. The *seller*, as well as the buyer, must make the deposit, and the deposits are treated by law, specifically section 4d(2) of the Commodity Exchange Act, as remaining the property of the depositor during the life of the futures contract. [525]

Thus, unlike a securities margin, the deposit made by both parties to secure their respective obligations under the futures contract entails no extension of credit whatsoever by either party or by any third party. It is separate and distinct from the purchase price of the commodity, which is not yet owed to the seller. In sum, a margin transaction in securities permits ownership despite an outstanding balance owed of up to 50 percent of the purchase price (a greater effective percentage is permitted in securities options transactions), and no funds are demanded in advance. In contrast, a futures transaction requires an advance deposit even before anything is owed and prohibits the transfer of title until 100 percent of the purchase price is paid.

Typically, the deposit made by each party when the futures contract is first entered is called the *initial margin*, implying—correctly—that additional deposits may be necessary. [526] The initial margin is not required prior to the trade but is due generally at or shortly after the time of the transaction. [527] The need for additional margin is usually triggered by changes in the market price of the contract. Thus, for example, if the market price of the futures contract declines so that the buyer (long) sustains a paper loss, that loss is deemed to erode the deposit that he originally made and a maintenance margin call for additional funds will be issued by his carrying broker (who acts as custodian of the deposit). Conversely, however, if the market price of the futures contract rises so that the buyer has a paper profit, he may usually withdraw an equivalent amount of the deposit originally made since the unrealized profit will act as protection in its place. The seller (short) is likewise subject to margin calls if a market price movement creates paper losses, and he too may make withdrawals from his original deposit if unrealized profits accrue. In other words, commodity margins are designed to assure that the trader's deposits always exceed his or her current market obligations.

Under clearinghouse rules, the carrying broker assumes responsibility for any trading losses sustained and not honored by its customers. [528] In the uncommon event that the carrying broker is unable to satisfy those obligations, the firm clearing the trade (if different) must pay, and if it is unable to do so, the loss is to be paid by the clearinghouse of the exchange. Thus, commodity margins serve not only to protect the parties against default, but the carrying brokers and clearinghouse as well.

Commodity margins are established by the clearinghouse where the transaction takes place, although a greater (but not lesser) margin may be demanded by the carrying broker. The CFTC is expressly prohibited by the Commodity Exchange Act from setting the level of margins for futures transactions, [529] The Act does not expressly speak to the CFTC's authority over options margins, and the CFTC has refused to concede that it lacks authority, although it has not yet affirmatively asserted controls over options margins.

Commodity margins often vary depending on the stage of the transaction, the nature of the trading involved, and the volatility of market prices. As noted above, an initial margin must be deposited for most new trades. This deposit is typically higher than the amount of deposit required to maintain that position after it is entered. A somewhat lower amount, called a maintenance margin, will support trading after the position is taken. The higher initial margin provides some additional funds so that, if a modest adverse price change occurs, it will not be necessary to issue a margin call immediately. In the event that market prices erode the deposit below the maintenance margin level, however, additional funds will be demanded and must be paid. [531]

The level of margin set by the clearinghouses may differ to reflect the varying risks associated with certain types of trading. Often, the margin is lower for hedging and spreading transactions. A hedging transaction involves taking a position in the market opposite to that person's interest in a physical commodity. [532] For example, a metals dealer who has bought an inventory of silver that he has not yet sold may acquire futures contracts to sell silver (short). A short futures contract becomes profitable if prices decline, and sustains losses if prices rise. The same price changes, of course, have the opposite effect on the value of the metals dealer's inventory—that is, declining prices erode the value of his inventory while rising prices enhance its worth. Therefore, whatever the direction that market prices move, this hedging metals dealer will witness an erosion of the value of one asset and a comparable gain in the other. In a sense, the hedger has minimized the risk of adverse futures price movement through countervailing inventory and, accordingly, poses less risk of default than the holder of a futures contract who has no offsetting assets. The clearinghouses generally recognize this fact by requiring a smaller margin from hedgers.

For much the same reason, the clearinghouse may set lower margins for spread transactions. [533] A spread trade occurs when the same party simultaneously acquires futures contracts to both buy and sell the same commodity, but for delivery in different months. Because these contracts are likely to follow similar price patterns, a loss on one side will usually be neutralized, at least in part, by gain in the opposite position. The extra asset here, then, is futures contracts that will ordinarily register gains as the other futures positions are incurring losses.

As noted earlier, the clearinghouse can become obligated to pay losses if the party and his carrying and clearing member brokers fail to do so. Accordingly, clearinghouses require that their members must pass through a fraction of the margins received from customers, to secure all of the trades submitted to the clearinghouse for acceptance (and all futures transactions must be so submitted). [534] These clearinghouse margins are distinct from the margin requirements for customers, and generally will be lower than the customer margin requirements for a variety of reasons. First, the clearinghouse settles all accounts daily with its members, collecting funds from members with net positions that show losses and paying out those funds to members with net positions having a profit. [535] This daily *marking to the market* has the effect of limiting the clearinghouse's risk to a single day's market price changes, while a carrying broker may have a customer's open positions on its books (and at its risk) for weeks or even months. Second, if margins are diligently collected from customers, a substantial additional amount of funds remains in the brokers' hands to call on in case of defaults. Moreover, brokers wish to retain the bulk of margin collections because they generate substantial interest income to the carrying firms. [536]

If there are insufficient assets in a customer's account to cover the necessary margin, the broker is required by clearinghouse rules to make a margin call. The customer agreement typically gives the broker reasonable discretion in the timing of such calls. [537] If the customer is unable to satisfy the margin call, the broker may liquidate positions in order to raise sufficient cash to establish a sufficient margin level. [537.1] Failure to give the customer adequate notice of a margin call can lead to claims of unauthorized trading in connection with liquidations and partial liquidations. [538] There are only "narrow" circumstances in which a broker will be relieved of the obligation to give the customer notice of a margin call. [539]

The level at which these commodity margins is set by the clearinghouses, and (if higher) by the carrying brokerage firms is frequently changed to reflect variations in market conditions and other risk factors. In highly volatile markets, for example, margins are commonly set at higher levels and may be made applicable to existing positions as well as new ones. Occasionally, different margin amounts are set for the same commodity, with a distinction made between some delivery months and others. In agricultural commodities, for example, futures contracts may exist for delivery months that involve either the current crop or the next, unharvested crop. A shortage of current supplies impacts on futures contracts for delivery in the present crop year but has less effect on the fulfillment of futures contracts that will not be deliverable until the new crop is harvested. Thus, clearinghouses may set different margin requirements for *old crop* and *new crop contracts.* Similarly, if a clearinghouse or a carrying broker perceives special risk in a futures contract for delivery in a particular month, margin levels in that one futures contract may be raised. In short, the level of margin on futures contracts is not static and is subject to change at any time.

Commodity margins are intended to secure the obligations of the parties, both seller and buyer, but they can sometimes have a market impact as well. Very high margins tend to discourage new entrants into the market, thus constricting access. [540] Existing market participants who have losing trades are placed under additional financial pressure from rising margin requirements, while traders with profitable positions can use that equity to meet the higher requirements. The market's performance can be affected to some degree, although it is exceedingly difficult, as a rule, to predict how (if at all) the price of the affected futures contract or contracts will be influenced by these developments. Clearinghouses, and carrying brokers, therefore, do not adjust margins with the conscious aim of causing prices to either rise or fall. Because the markets remain open for competitive trading among those participants able to meet margin requirements, prices continue to be determined—as before—by economic events and the interaction of the traders.

Over the years, there have been developments regarding the margining procedures for certain types of contracts. In late 1988, the Commission approved the Chicago Mercantile Exchange's plan to establish commodity option margins on a portfolio basis that measures the aggregate risk of commodity options and futures contracts rather than valuing the margins separately. [541] Subsequently, the Chicago Mercantile Exchange and the Chicago Board of Trade requested that the Commission change the manner in which commodity option contract margins are computed. [542] Former Regulation section 33.4(a)(2), [543] which required payment of the full option premium for each option purchased, has been rescinded and commodity options margins are computed on the same basis as margins for futures contracts [544] in that an original margin is established according to two components: the underlying risk and a variable margin computed on the basis of daily fluctuations in the premium value. [545]

Another development occurred when the Chicago Mercantile Exchange and the Options Clearing Corporation (OCC) announced a cross-margining agreement; the terms of the agreement were designed to permit a single margin balance for futures and securities options hedged positions which are carried on different exchanges. [546] The cross-margining agreement required approval of both the CFTC and the SEC before it could be put into effect. [547] In September 1989, the CFTC and the SEC approved the cross-margining proposal of the CME and OCC. Cross-margining allows exchanges to coordinate the setting of margin levels in connection with a hedged position when one side of the position is on a commodity exchange and the other is on a securities exchange. Cross-margining sets margin levels in consideration of the true risk related to all components of a portfolio consisting of both futures contracts and securities options. [548] Cross-margining also reduces dollar transfers between the two clearing organizations. [549]

The Futures Trading Practices Act of 1992 gave the Federal Reserve Board oversight authority with regard to margins on stock index futures. This was intended to facilitate coordination with securities margins that are subject to Federal Reserve Board regulation. In 1993, the Federal Reserve Board delegated to the Commission the establishment of both initial margin requirements and margin maintenance levels for stock index futures contracts and options. [550] And, as noted earlier, security futures products are subject to the same margin rules as options on securities. [551]

The rights and obligations arising out of commodity margins is a matter of federal law. Accordingly it has been held that state law in this area is preempted by federal law. [552]

[A] Uncleared Swap Margin

Authority to establish margin requirements for uncleared swaps is divided among three sets of regulators. The U.S. banking regulators—primarily the Federal Reserve, FDIC, and Office of the Comptroller of the Currency—are responsible for adopting uncleared swap margin rules for banks that are swap dealers and major swap participants; the CFTC is responsible for adopting uncleared swap margin rules for nonbank swap dealers and major swap participants; and the SEC is responsible for establishing uncleared security-based swap margin rules for nonbank security-based swap dealers and major security-based swap participants. [553] Some swaps will continue to be transacted bilaterally without being cleared; for example, where a swap is not required to be cleared (and the counterparties do not choose to clear it) or where the counterparties elect to rely on a clearing exception.

Following the initial proposals in 2011, [554] 2014, [555] and in November 2015 and January 2016, the U.S. banking regulators and the CFTC each adopted final margin rules for uncleared swaps. [555.1]

The rules, which are largely consistent with each other, incorporate the Basel Committee on Banking Supervision's and the International Organization of Securities Commissions' 2013 Final Policy Framework on Margin Requirements for Non-Centrally Cleared Derivatives. [556] In response to comments to the proposals, the final rule does not require initial or variation margin for uncleared swaps with non-financial end users. Furthermore, as a result of changes to the CEA made in the Terrorism Risk Insurance Program Reauthorization Act of 2015 (“TRIPRA”), [557] swap dealer and major swap participant initial and variation margin requirements for uncleared swaps adopted by either the prudential regulators or the CFTC, as applicable, do not apply to a swap in which the counterparty either qualifies for the end-user exception from mandatory clearing in CEA section 2(h)(7)(A), qualifies for an exemption from mandatory clearing for cooperatives, or satisfies the criteria in CEA section 2(h)(7)(D) as an entity acting solely on behalf of and as agent for an affiliate that satisfies the end-user exception. Furthermore, TRIPRA amends the Securities Exchange Act of 1934 (“Exchange Act”) to clarify that security-based swap dealer and major security-based swap participant initial and variation margin requirements for uncleared security-based swaps adopted by either prudential regulators or the SEC, as applicable, do not apply to a security-based swap in which the counterparty qualifies for the end-user exception from mandatory clearing in Exchange Act section 3C(g)(1) or satisfies the criteria in Exchange Act section 3C(g)(4) as an entity acting solely on behalf of and as agent for an affiliate that satisfies the end-user exception.

On August 19, 2016, the SEC Division of Trading and Markets issued a no-action letter stating that a broker-dealer must deduct the value of margin collateral posted to a swap dealer or other counterparty for a non-cleared swap under paragraph (c)(2)(iv)(E) of Exchange Act Rule 15c3-1. The Division of Trading and Markets staff will not seek enforcement if the value of the collateral is not deducted if three conditions are met: (i) The initial margin requirement is funded by a fully executed written loan agreement with an affiliate of the broker-dealer; (ii) the loan agreement provides that the lender waives re-payment of the loan until the initial margin is returned to the broker-dealer; and (iii) the broker-dealer's liability to the lender can be fully satisfied by delivering the collateral serving as initial margin to the lender. By contrast, for cleared swaps, the Division of Trading and Markets will not recommend enforcement if a broker-dealer does not deduct the value of the collateral posted to a DCO from net worth when computing net capital. [557.1]

The variation margin compliance deadline for a given covered swap entity and counterparty is either September 1, 2016 or March 1, 2017, and the initial margin compliance deadline is phased in between September 1, 2016 and September 1, 2020, depending upon the size of the swap entity (and its affiliates), as well as combined swap positions with the counterparty. [557.2] However, in 2020, the U.S. banking regulators and CFTC amended their respective rules to introduce an additional compliance phase for initial margin, phase 5, with a compliance date of September 1, 2020, and to postpone the compliance date for the last phase with smaller financial end user counterparties, now phase 6, to September 1, 2021. [557.3] The agencies separately adopted interim final rules, subject to comment, to push out to September 1, 2021 the compliance date for phase 5, to address operational challenges resulting from the coronavirus pandemic. [557.4] The U.S. banking agencies, in their interim rulemaking, also further postponed the phase 6 compliance date, to September 1, 2022, but the CFTC did not. Instead, the CFTC initiated a separate rulemaking proposal that would, if adopted, postpone the phase 6 compliance date to September 1, 2022. [557.5]

In November 2013, the CFTC issued final rules to implement the Dodd-Frank Act requirements that SDs and MSPs: (i) notify their uncleared swap counterparties of the right to have segregated the property provided to margin their swap obligations and (ii) upon the counterparty's exercise of that right, segregate such property, in accordance with CFTC rules, in an account separate from the assets of the SD or MSP. [558] The CFTC's reproposed rules for uncleared swap margin requirements included proposed conforming changes to the segregation rules to clarify that notification of a counterparty's right to segregation of initial margin is not required where segregation of initial margin for uncleared swaps is mandatory pursuant to CFTC margin rules. [559] The new segregation rules specify the timing and content of the required notice of the right to segregation, require that the SD or MSP obtain a confirmation of receipt from the counterparty of the segregation notice, and establish requirements for an independent custodian, the terms of the custodial agreement and limitations on withdrawal of margin from the account. [560] In October 2014, in response to "several inquiries regarding the practical implementation of the Commission's regulations," the CFTC Division of Swap Dealer and Intermediary Oversight issued a no-action letter clarifying the Division's views that:

1. the requirement that an SD or MSP provide annual notification to each counterparty to an uncleared swap transaction of such counterparty's right to elect to require segregation of initial margin continues to apply in any calendar year in which the SD or MSP enters into a new uncleared swap transaction with the counterparty. The SD or MSP is required to provide the annual notification whether or not the counterparty previously made an election to require the SD or MSP to segregate initial margin;
2. the annual notification and quarterly reporting requirements are not applicable if no initial margin is required to be posted by a counterparty or collected by an SD or MSP either by contract or regulation; and
3. an SD or MSP is not prohibited from relying on negative consent in complying with its obligations to obtain from its counterparty (a) confirmation of the counterparty's receipt of the annual notice provided by the SD or MSP and (b) the counterparty's election to require or not require segregation. [561]

The rules limit investment of margin held in segregation to the investments specified in CFTC Rule 1.25. [562] The new rules do not address segregation of variation margin, restrict the types of acceptable collateral, or limit the manner of allocating gains and losses resulting from investments of collateral. [563]

On May 31, 2016, the CFTC published a final rule with respect to the cross-border application of margin requirements for uncleared swaps applicable to covered swap entities, providing circumstances under which an entity may satisfy the margin rule by complying with comparable foreign margin requirements if, upon request, the CFTC found that such foreign jurisdiction's margin requirements were comparable to the CFTC's margin requirements. [563.1] Subsequently, in February 2017, the CFTC's Division of Swap Dealer and Intermediary Oversight issued relief from compliance with certain CFTC uncleared swap margin requirements when the entity enters into swaps with counterparties subject to the non-centrally cleared over-the-counter derivative margin requirements applicable in the European Union. [563.2]

In May 2018, the Commission issued a proposed rule amending the CFTC's margin requirements for SDs and MSPs. [563.3] Among other things, under the proposed rule, master netting agreements would be included in the definition of "eligible master netting agreement" because those agreements must also comply with rules adopted by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation ("FDIC"), and the Office of the Comptroller of the Currency ("OCC") for qualified financial contracts ("QFC"). Further, any legacy uncleared swap not subject to the CFTC's margin requirements would not become so subject if it were to be amended solely in order to comply with the QFC rules.

In April 2020, the CFTC amended its uncleared margin rule to add the European Stability Mechanism to the list of entities that are excluded from the definition of financial end user under the rules. [563.4] The CFTC proposed the amendments in October 2019 to incorporate the terms of no-action relief it had granted to the European Stability Mechanism in 2017. [563.5]

[B] Cleared Swap Margin

Initial margin requirements for cleared swap transactions are based on the rules of the DCO, subject to CFTC requirements. The CFTC rules require that a DCO must require its FCM members to collect customer initial margin for non-hedge positions at a level that is greater than 100 percent of the DCO's initial margin requirements with respect to each product and swap portfolio. [564] DCOs are accorded reasonable discretion to determine the percentage by which such margins must exceed the DCO's requirements. [565] The amount of initial margin required for cleared swap transactions is calculated by the DCO based on internal models that must be reviewed and validated by an independent party on a regular basis. These models must use a minimum liquidation time of one day for agricultural, energy and metal swaps and five days for all other swaps.

Variation margin is determined by the DCO's daily, and often intra-daily, measurement of credit exposure to each clearing member. CFTC rules require that a DCO mark-to-market each clearing member's open house and customer positions at least once each business day and ensure its operations will not be disrupted by potential losses from defaults by its clearing members and that non-defaulting clearing members are not exposed to losses that they cannot anticipate or control. [566]

In addition to margin requirements for cleared swap transactions, the CFTC has issued rules on the protection of customer swap collateral, the “legally segregated, operationally commingled” (LSOC) model. [567] Under the LSOC model, if a customer of an FCM defaults on margin obligations for a cleared transaction and the FCM is not able to satisfy the defaulting customer's obligations, the DCO has no recourse to funds of the FCM's non-defaulting customers. [568] The clearing member FCM cannot use the funds of any other customer to satisfy the margin payment to the DCO and remains responsible for providing the margin payment to the DCO. [569] This means that clearing firm bankruptcies due to customer defaults will likely require the DCO to use its guarantee funds or other resources to make good any remaining losses to cleared swap customers of the failed clearing member.

Footnotes

1 Derivatives that are based on securities must also be considered. The definition of *security* is found in section 2(a)(1) of the Securities Act of 1933 and section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. §§77b(a)(1), 78c(a)(10). A detailed analysis of the definition of *security* can be found in 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §1.6 (Practitioner's Ed. 4th ed. 2002). *See also id.* § 1.7 (dealing with derivatives and the securities laws).

2 7 U.S.C. §1a, CCH Rep. ¶ 1001.

3 *E.g.*, Stroud v. Meister, 2001 U.S. Dist. LEXIS 2886 (N.D. Tex. 2001) (interests in a joint venture involving purchases of luxury limousines were not subject to the commodities laws nor were they securities subject to the securities laws).

4 *See* the Complaint in CFTC v. Enron Corp., H-03-909 U.S. District Court for the Southern District of Texas (Houston Division) (S.D. Tex. Filed March 12, 2003).

5 *See* 7 U.S.C. §1a, CCH Rep. ¶ 1011.

6 7 U.S.C. §13-1. Futures contracts on onions were prohibited in 1958 because of a perceived adverse effect that futures trading had on cash crop prices. Pub. L. 85-839. See H.R. Rep. 1036, 85th Cong., 1st Sess. (Aug. 8, 1957), 1958 U.S. Code Cong. & Admin. News 4210-4217.

The exclusion of onions has withstood constitutional attack. *See* Chicago Mercantile Exch. v. Tieken, 178 F. Supp. 779 (N.D. Ill. 1959) (excess speculation in onion futures resulted in unwarranted volatility in cash price of onions; this was detrimental to onion producers and provided a rational basis for the exclusion of onions). As one court observed, "This provision brought tears to the eyes of at least some would-be onion futures traders." Salomon Forex, Inc. v. Tauber, 24 Sec. Reg. & L. Rep. (BNA) 846, n.10 (N.D. 111. 1992).

6.1 Section 1a(9), 7 U.S.C. § 1(a)(9), CCH Rep. ¶ 1002, as amended by Dodd-Frank Wall Street Reform and Consumer Protection Act § 721, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010). *See also*

7 U.S.C. § 13-1(a). This amendment vacated CFTC designations of contract markets in motion picture box office receipts, which included a statement of the commission that provided an interesting interpretation on the definition of commodity and comment on the economic purpose of designated contract markets. Statement of the Commission dated June 14, 2010, which can be found at http://www.cftc.gov/ucm/groups/public/@otherif/documents/ifdocs/mdexcommissionstatement061410.pdf.

6.2 *See* CFTC Press Rel. No. 6224-12, CFTC Issues Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts, available at http://www.cftc.gov/PressRoom/PressReleases/6224-12 (CFTC Apr. 2, 2012).

7 *Cf.* CFTC v. Standard Forex, [1994–1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,786 (E.D.N.Y. 1996) (subject matter jurisdiction existed over supposed "spot transactions" that had futures contract characteristics).

8 *See* Phillip McBride Johnson, Starting From Scratch, Derivatives Use Trading and Regulation, vol. 3, number 4 at 284 (1997).

9 Although the exclusionary language of §1a does not say so expressly, the legislative history of the exclusion suggests that Congress was contemplating only transactions among large, sophisticated financial institutions. The Department of the Treasury presented this proposal for exclusion with reference only to banks and similar institutions, and the amendment was viewed in this manner by the Congress. *See* Report on H.R. 13113 of the Senate Agriculture and Forestry Committee, S. Rep. No. 1131, 93d Cong., 2d Sess. 49-51 (Aug. 29, 1974); Report on H.R. 13113 of the Committee of Conference, H.R. Rep. No. 1383, 93d Cong., 2d Sess. 35 (Sept. 29, 1974). However, the U.S. Supreme Court adopted a literal reading of this provision, which makes no express distinction between institutions and the general public, and held that all off-exchange transactions, including futures and options, are excluded from CFTC jurisdiction. Dunn v. CFTC, 117 S. Ct. 913 (1997). The amendments to the Act brought in by the Commodity Futures Modernization Act of 2000 restored the CFTC's jurisdiction over sales to the general public.

10 7 U.S.C. §2, CCH Rep. ¶ 1011.

11 Report on H.R. 13113 of the Senate Agriculture and Forestry Committee, S. Rep. No. 1131, 93d Cong., 2d Sess. 49-51 (Aug. 29, 1974).

12 795 F. Supp. 768, 772, n.10 (E.D. Va. 1992), *aff d*, 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 114 S. Ct. 1540 (1994). *Accord*, CFTC v. Frankwell Bullion Ltd., 99 F.3d 299 (9th Cir. 1996), *affi'g* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,484 (N.D. Cal. 1995). Cf. CFTC v. Baragosh, 278 F.3d 319, 327-329 (4th Cir. 2002) (rejecting argument that Congress intended to exempt all futures trading unless conducted on formally organized futures exchange; transactions in foreign currency are subject to CFTC jurisdiction if they are small, standardized, offered as-is, and mass-marketed to individuals); Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 118, 156-157 (S.D.N.Y. 2000). *See also* C.R. Webb (Note), Salomon Forex, Inc. v. Tauber [8 F.3d 966 (1993)] —The "Sophisticated Trader" and Foreign Currency Derivatives Under the Commodity Exchange Act, 19 N.C. J. Int'l & Com. Reg. 597 (1994).

13 CFTC v. Dunn, 58 F.3d 50 (2d Cir. 1995), *rev'd*, 519 U.S. 465 (1997). The Supreme Court granted certiorari in the *Dunn* case in the spring of 1996. *See also* CFTC v. Standard Forex, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,062 (E.D.N.Y. 1994).

14 Dunn v. CFTC, 519 U.S. 465 (1997).

15 Justice Scalia, concurring, reasoned it was unnecessary to go beyond the language of the statute to reach this result. He observed that resort to legislative history to reach this result added "nothing useful" and could only act to "sow confusion in the law."

16 Section 2(c), 7 U.S.C. §2(c), CCH Rep. ¶ 1023.

17 *See generally* David J. Gilberg, Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws, 39 Vand. L. Rev. 1599 (1986).

18 *See infra* §§ 1.02[9], 3.05[7] - 3.05[8].

19 *See* 46 Fed. Reg. 54,500 (1981).

20 Futures Trading Act of 1982, Pub. L. 94-444, §206, 96 Stat. 2294.

21 Futures Trading Act of 1986, Pub. L. 99-641, 100 Stat. 3556, codified at 7 U.S.C. §6c(c), CCH Rep. ¶ 1061.

22 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The CFMA is discussed in greater detail *supra* §1.02[8][F].

23 15 U.S.C. §§77b(a)(1), 78c(10).

24 *See, e.g.*, SEC v. Belmont, Reid & Co., 794 F.2d 1388 (9th Cir. 1986) (gold coins not subject to securities laws); Stenger v. R. H. Love Galleries, 741 F.2d 144 (7th Cir. 1984) (artwork sold with repurchase agreement not a security); Noa v. Key Futures, 638 F.2d 77 (9th Cir. 1980) (silver bars not subject to securities laws).

25 *See* 1,4 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §§1.6, 22.6 (Practitioner's Ed. 4th ed. 2002).

26 *E.g.*, Lopez v. Dean Witter Reynolds, 805 F.2d 880 (9th Cir. 1986) ; Point Landing v. Omni Cap. Int'l, 795 F.2d 415 (5th Cir. 1986), *aff'd on other grounds sub nom.* Omni Cap. Int'l v. Rudolph Wolff & Co., 484 U.S. 97 (1987).

27 *See generally* David J. Gilberg, Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws, 39 Vand. L. Rev. 1599 (1986).

28 7 U.S.C. §2 (1999) (amended 2000). For preemption of other federal agencies, *see* Point Landing v. Omni Cap. Int'1, 795 F.2d 415 (5th Cir. 1986), *cert. granted sub nom.* Omni Cap. Int'l v. Rudolph Wolff & Co., 107 S. Ct. 946 (1987), *rev'd on other grounds*, 484 U.S. 97 (1987) (CFTC had exclusive jurisdiction over commodities futures, including managed accounts); SEC v. American Commodity Exch., 546 F.2d 1361 (10th Cir. 1976) ; American Grain Ass'n v. Canfield, Burch & Mancuso, 530 F. Supp. 1339 (W.D. La. 1982) (jurisdiction under Commodity Exchange Act preempted any action under the securities laws). *Accord*, Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th-Cir. 1982). For preemption of state regulatory statutes, *see, e.g.*, Mallen v. Merrill Lynch, Pierce, Fenner & Smith, 605 F. Supp. 1105 (N.D. Ga. 1985), *cert. granted sub nom.* Omni Cap. Int'l v. Rudolf Wolff & Co., 484 U.S. 97 (1987) ; Bell v. International Trading, 556 S.W.2d 420 (Ark. 1977), *cert. denied*, 436 U.S. 956 (1978); State v. Coin Wholesalers, 311 Minn. 346, 250 NW.2d 583 (1976) ; State v. Monex Int'l, 527 SW.2d 804 (Tex. 1975). *But see* Pettigrew v. Oppenheimer & Co., 582 F. Supp. 98 (D. Mass. 1984) (no preemption where state statute did not attempt substantive regulation); Schlatter v. Mo-Comm Futures, 662 P.2d 553 (Kans. 1983) (Commodity Exchange Act did not preempt state securities laws). For further discussion, *see infra* §4.05[12].

See generally Philip Johnson, The Commodity Futures Trading Commission: Preemption as Public Policy, 29 Vand. L. Rev. 1 (1976). *See also* David J. Gilberg, Regulation of New Financial Futures Under the Federal Securities and Commodities Laws, 39 Vand. L. Rev. 1599 (1986).

29 The Commodity Futures Modernization Act of 2000, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000) (CFMA), eliminated the contract market monopoly and permits over-the-counter trading of commodity products under specified conditions. The CFMA also permitted for the first time futures on individual securities. The CFMA is discussed in greater detail *infra* §1.02[8][F].

30 7 U.S.C. §2, CCH ¶ 1011. The statute provides that the SEC shall be given notice of all applications by a board of trade to trade a futures contract on a broadly-based index. If the SEC determines that the trading of such a contract (or option on the contract) is readily susceptible to manipulation or if the group or index is not composed largely of unaffiliated and widely traded securities, then the CFTC must hold a hearing considering the SEC's objections. For applications filed on or after December 9, 1982, the SEC may exercise a veto power based on the above standards. In addition, the CFTC and SEC apply these standards in reviewing stock index futures contracts that foreign exchanges wish to offer in the United States. Foreign Futures and Foreign Options Transactions, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,740 n.6, at p.33,920 (CFTC Aug. 5, 1987). Narrow-based indexes do not fall under this provision as they qualify as security futures

products. 7 U.S.C. §2(a)(1)(C)(i)(III). Security futures products are governed by and are discussed *infra* §1.02[9].

For example, in 1988 the SEC opposed a CFTC proposal to regulate certain hybrid financial instruments. *See* SEC Criticizes CFTC Draft Proposal to Extend Regulation to Hybrid Products, 20 Sec. Reg. & L. Rep. (BNA) 1348 (Aug. 26, 1988).

As discussed *infra* §1.02[5], in July 1989, the CFTC adopted rules exempting certain hybrid instruments that had characteristics common to both securities and commodities options. Contemporaneously the CFTC issued a statutory interpretation where securities and futures-type attributes existed. A number of commentators responded to the CFTC's initial statutory interpretation concerning debt instruments. In 1990, the Commission issued a revised statutory interpretation that broadened the exemptions available to hybrid options. Among other things, the exemption applies to preferred equity securities as well as debt depository instruments and is dependent upon a commodity-independent yield of at least 50 percent but no more than 150 percent of the estimated yield at the time of issuance of a comparable nonhybrid instrument. *See* Statutory Interpretation Concerning Certain Hybrid Instruments, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,805 (CFTC Apr. 11, 1990). *See generally* Meer, Hybrid Investments: Their Treatment Under Recent Commodity Futures Trading Commission Releases, 46 Bus. Law. 405 (1991); Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. 1 (1996). Amendments to the Act in year 2000 excluded from the Act hybrid instruments that are predominantly securities. Section 2(f), 7 U.S.C. §2(f), CCH Rep. ¶ 1026.

31 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

31.1 *See, e.g.,* CFTC-SEC Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(Vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(Vi) of the Securities Exchange Act Of 1934, Sec. Exch. Act Rel. No. 49469, Release No. 34-49469, 82 S.E.C. Docket 1811, 2004 WL 598172 (SEC Mar. 25, 2004).

32 Board of Trade of the City of Chicago v. SEC, 187 F.3d 713 (7th Cir. 1999).

33 *See* 7 U.S.C. §2, CCH ¶ 1011.

34 Section 1a(25), 7 U.S.C. §1a(25), CCH Rep. ¶ 1002.

35 The three securities exchanges were the American Stock Exchange, the Philadelphia Stock Exchange, and the Chicago Board Options Exchange.

36 *See* CFTC Letter to Senate Agriculture Committee Chairman Patrick Leahy (May 16, 1989), as reported in 21 Sec. Reg. & L. Rep. (BNA) 785 (May 26, 1989). *See also* CFTC amicus brief in Chicago Board of Trade v. SEC, Nos. 89-1538, 89-1763, 89-1786 (7th Cir. May 5, 1989), as reported in 21 Sec. Reg. & L. Rep. (BNA) 860 (June 9, 1989).

37 Sec. Exch. Act Rel. No. 34-26709 (Mar. 14, 1989).

38 *See* Ricks, Stock Basket Approval Stirs Court Action, Wall St. J., Mar. 15, 1989, p.C 1. *See also infra* §§4.05[2], 4.05[11].

39 *See* Ricks, Stock Basket Approval Stirs Court Action, Wall St. J., Mar. 15, 1989, p.C 1. The CFTC filed an amicus brief supporting its exclusive jurisdiction over index participation units and thus opposing their listing on securities exchanges. *See* CFTC Tells Seventh Circuit That Index Participations Are Futures, 21 Sec. Reg. & L. Rep. (BNA) 360 (June 9, 1989).

40 Chicago Board of Trade v. SEC, Nos. 89-1538, 89-1763, 89-1786 (7th Cir. May 5, 1989), as reported in 21 Sec. Reg. & L. Rep. (BNA) 785 (May 26, 1989).

41 Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

42 Section 2(a)(1)(b), 8 U.S.C. §2a, CCH Rep. ¶ 1011A.

43 Chicago Mercantile Exch. v. SEC, 883 F.2d 537 (7th Cir. 1989), *cert. denied*, 496 U.S. 936 (1990).

44 The SEC also has the responsibility for registering clearing agencies for exchanges. 15 U.S.C.A. 78q-1.

45 Board of Trade of City of Chicago v. SEC, 883 F.2d 525 (7th Cir. 1989). The Seventh Circuit agreed with the commodities exchanges' contention that the SEC first had to make a formal determination whether the activity in question in fact involved operating as a securities exchange.

46 *See* 22 Sec. Reg. & L. Rep. (BNA) 56 (Jan. 12, 1990).

47 *See infra* §§4.05[8], 4.05[11].

48 *See* 22 Sec. Reg. & L. Rep. (BNA) 731 (May 11, 1990).

49 *See* Report on S. 648 or the Senate Committee on Banking, Housing, and Urban Affairs, S. Rep. No. 3000, 101st Cong., 2d Sess. (May 22, 1990).

50 *See* Report on S. 207 of the Senate Committee on Agriculture, Nutrition and Forestry, Rep. No. 102-22, 102d Cong., 1st Sess. (March 12, 1991). Under the proposed amendment, the Act would not apply to commodity options if less than 50 percent of its value derives from the commodity option. Nor would it apply to futures contracts where it is expected that less than 50 percent or its change in value will be attributable to the underlying commodity. *Id*. The proposed legislation would also allocate to the SEC jurisdiction over index participation units that had been approved by or proposed to the SEC before 1991. The parallel House legislation did not address jurisdictional issues, leaving the matter to be resolved in conference.

51 OTC Derivative Markets and Their Regulation; [1992-1994 Transfer Binder] Comm. Fut. L. Rep. ¶ 25,877 (Oct. 1993). See Finkle, The CFTC's Study of Swaps and Oft-Exchange Derivatives Trading: A Review, 13 Fut. Int'l L. Ltr. 1 (Nov./Dec. 1993). *See also* R. Leon (Note), The Regulation of Derivatives and the Futures Trading Practices Act of 1992, 3 J.L. & Policy 321 (1994).

52 Section 2(f), 7 U.S.C. §2(f), CCH Rep. ¶ 1026.

53 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The CFMA is discussed in greater detail *infra* §1.02[8][F]. Equity-based futures contracts and security futures are discussed in *infra* §1.02[9].

54 *See* Reg. §41.21(b), 17 C.F.R. §41.21(b), CCH Rep. ¶ 2895, for the listing criteria applicable to narrow-based indexes. Some of the indexes trading prior to the CFMA might not have qualified as broad-based indexes under the amended Act. Accordingly, the CFTC and the SEC issued a joint order grandfathering those existing contracts as broad-based indexes by excluding them from the category of narrow-based indexes. Joint Order Regarding the Definition of Narrow-Based Security Index Those Security Indexes That Qualified for the Exclusion From That Definition Under Section 1A(25)(b)(v) of the Commodity Exchange Act and Section 3(a)(55)(c)(V) of the Securities Exchange Act of 1934,k Sec. Act Rel. No. 33-46009, 2002 WL 1114177 (SEC/CFTC May 31, 2002). *See also, e.g.*, Joint Order Granting the Modification of Listing Standards Requirements Under Section 6(h) of the Securities Exchange Act of 1934 and the Criteria Under Section 2(a)(1) of the Commodity Exchange Act, Sec. Exch. Act Rel. No. 34-1340142 (SEC/CFTC June 19, 2002).

55 Regs. §§41.42 - 41.49, 17 C.F.R. §§41.41 - 41.49, CCH Rep. ¶ 2909A-2909H; Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. 53146-01, 2002 WL 1840540 (CFTC Aug. 14, 2002). The margin requirements are discussed *infra* §§1.02[13], 2.06[2].

56 Regs. §§34.1 - 34.3, 17 C.F.R. §§34.1 - 34.3, CCH Rep. ¶ 2761-2763. *See* Regulation of Hybrid Instruments, 58 Fed. Reg. 5580, [1992-1994 Transfer Binder] Comm. Fut. 1. Rep. (CCH) ¶ 25,538 (CFTC Jan. 22, 1993). *See also, e.g.*, Pietrzak & Sackheim, CFTC Exemption Procedures for Novel Derivative Transactions, 26 Rev. Sec. & Comm. Reg. 121 (1993).

57 Reg. §34.3(a)(1), 17 C.F.R. §34.3(a)(1), CCH Rep. ¶ 2763. "A demand deposit, time deposit or transaction account within the meaning of 12 C.F.R. §§204.2(b)(1), (c)(1), and (e), respectively, offered by an insured depository institution as defined in Section 3 of the Federal Deposit Insurance Act; an insured credit union as defined in Section 101 of the Federal Credit Union Act; or a Federal or State branch or agency of a foreign bank as defined in Section 1 of the International Banking Act." Reg. §34.3(a)(1)(ii), 17 C.F.R. §34.3(a)(1)(ii), CCH Rep. ¶ 2763.

58 Reg. §34.3(a)(2), 17 C.F.R. §34.3(a)(2), CCH Rep. ¶ 2763. Commodity dependent value is defined in terms of that portion of the value that results from indexing to, or calculation by reference to, the price of a commodity. Reg. §§34.2(d)(4), (e), 17 C.F.R. §§34.2(d), (e), CCH Rep. ¶ 2762. *Cf.* CFTC Interpretative Ltr. No. 94-93

[1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,249 (CFTC Oft-Exchange Task Force July 27, 1994) (financial instruments based on the pricing of a single company's stock were economically equivalent to options on individual stocks and thus were neither futures contracts nor subject to the CFTC's jurisdiction); CFTC Interpretative Ltr. No. 94-32, [1992-1994 Transfer Binder] Comet. Fut. L. Rep. (CCH) ¶ 26,042 (CFTC Off-Exchange Task Force Feb. 4, 1994) (same). *See generally* Karol & Lehman, Equity Derivatives, 27 Rev. Sec. & Commod. Reg. 121 (1994).

59 Reg. §34.3(a)(4), 17 C.F.R. §34.3(a)(4), CCH Rep. ¶ 2763.

60 Reg. §34.3(a)(3), 17 C.F.K. §34.3(a)(3), CCH Rep. ¶ 2763. The regulation makes clear that the full payment requirement precludes provisions for additional out-of-pocket payments to the issuer during the life of the instrument.

61 In contrast, the exemption for swap transactions does not include an exemption from the antifraud and antimanipulation provisions. *See* discussion *infra.*

62 Reg. §34.3(a) specifically refers to section 2(a)(1)(B) of the Act. As part of the Commodity Fututres Modernization Act of 2000 (Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)). While former section 2(a)(1)(B) prohibited, among other things, futures contracts on individual corporate shares (equity), the Commission permitted continued reliance on its 1990 Statutory Interpretation Concerning Hybrid Instruments in lieu of this new exemptive authority. The Statutory Interpretation is not expressly limited in the way that the exemptive power is restricted, and there have been some hybrid offerings evidently under the Statutory Interpretation that have features akin to an imbedded futures contract on corporate shares. This became moot with the adoption of the Commodity Futures Modernization Act of 2000 that expressly permits future contracts on individual securities under the new category of securities future products. *See infra* §1.02[9].

63 17 C.F.R. §34.3(a), CCH Rep. ¶ 2763.

64 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The CFMA is discussed in greater detail *infra* §1.02[8][F].

65 Section 2(f), 7 U.S.C. §2(f), CCH Rep. ¶ 1026, CFMA §105. The amendment in year 2000 eliminated CFTC jurisdiction over hybrid securities, even when offered to the general public, if full payment was made at or near the outset, there was no further payment obligation, there was no routine mark-to-market margining, and the instrument was not marketed as a futures contract (or option thereon). *Id.*

65.1 *See* Section 5b, 7 U.S.C. § 7a-1, CCH Rep. ¶¶ 1206–1212A, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law No. 111-203 § 725, H.R. 4173 (111th Cong. 2d sess. 2010).

66 §4(c)(5)(B), 7 U.S.C §6(c)(5)(B), CCF1 Rep. ¶ 1035, authorized the Commission to exempt swap agreements "that are not part of a fungible class of agreements that are standardized as to their material economic terms, to the extent that such agreements may be regarded as subject to the Act." In contrast, swaps are not subject to the securities laws. *See* Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996) (interest rate swaps lacked commonality and thus were not investment contracts under the securities laws).

67 §4(c)(5)(B), 7 U.S.C. §6(c)(5)(B), CCH Rep. ¶ 1035.

68 *Id.* The bankruptcy code, 11 U.S.C. §101(53), provides that a "swap agreement" is:

> (A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);
>
> (B) any combination of the foregoing; or
>
> (C) a master agreement for any of the foregoing, together with all supplements.

69 *Cf.* Louis Vitale, Comment, Interest Rate Swaps Under the Commodity Exchange Act, 51 Case W. Res. L. Rev. 539 (2001) (suggesting, among other things, that the Commodity Futures Modernization Act of 2000 did not eliminate all interpretative problems with respect to over-the-counter interest rate swap transactions).

70 Reg. §35.2, 17 C.F.R. §35.2, CCH Rep. ¶ 2771.

71 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

72 While relief for swaps under the new exemptive authority is thus restricted, the Commission stated that reliance may continue to be placed on its 1989 Policy Statement Concerning Swap Transactions, which does not contain a similar limitation.

73 By virtue of subsection (vi), in addition to the foregoing institutional participants, the exemption is available to corporations, partnerships, trusts, and other entities not formed solely for qualifying for the exemption as eligible swap participants (A) if they have more than $10 million total assets, (B) if their obligations under the swap agreement are guaranteed by an entity that is a qualified swap participant (other than securities brokers, FCMs, FBs, FTs, and individuals) under the Regulation, or (C) if they have a net worth in excess of $1 million and the swap agreement is entered into either in connection with their business or to manage the risk of an asset or liability of the business. Reg. §35.1(2)(vi), 17 C.F.R. §35.1(2)(vi), CCH Rep. ¶ 2771.

Individuals may not qualify for the exemption as the exemption is limited to eligible participants that are entities. *See, e.g.*, CFTC Interpretative Ltr. No. 95-61, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,463 (CFTC Initial Dec. 1995) (natural persons with a net worth of $1 million or more are not eligible to participate in exempt swap transactions).

74 Reg. §§35.1(2)(1)-(xi), 17 C.F.R. §§35.1(2x1)-(xi), CCH Rep. ¶ 2771.

75 Reg. §35.2(b), 17 C.F.R. §35.2(b), CCH Rep. ¶ 2772, CFTC Interpretative Ltr. No. 98-01, [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,226 (CFTC Div. of Trading & Markets Jan. 7, 1998). This is required by the statutory authorization.

76 Reg. §35.2(c), 17 C.F.R. §35.2(c), CCH Rep. ¶ 2772.

77 Reg. §35.2(d), 17 C.F.R. §35.2(d), CCH Rep. ¶ 2772. The Regulation also prohibits "multilateral transaction facilities," which are physical or electronic facilities that link market participants simultaneously with the capability of entering into binding contracts among themselves. This restriction is separate from the Commission's clearing house policy which is based on the creditworthiness standard. The limitation is designed to preclude centralized trading (including screen-based trading) but is not meant to preclude access to computerized information so long as the swap participants do not use the systems to enter orders or execute transactions. *See* Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,539 (CFTC Jan. 22, 1993). *See also, e.g.*, CFTC Interpretative Ltr. No. 93-66, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,785 (CFTC Div. of Trading & Markets June 18, 1993) (nonprofit electronic market established for academic research granted no action relief).

78 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The CFMA is discussed in greater detail *infra* §§1.17, 1.18.

79 Section 2(g), 7 U.S.C. § 2(g), CFMA § 105, CCH Rep. ¶ 1027. Prior to the effective date of its repeal, former section 2(g) was broadly interpreted. Thus, for example, the Fifth Circuit rejected the government's contention that in the absence of a finalized trade or contract the exemption could not apply. United States v. Radley, 632 F.3d 177 (5th Cir. 2011). In so ruling the court rejected dictum in its earlier unpublished decision in United States v. Futch, 278 Fed. Appx. 387, 392 (5th Cir. 2008). *Accord* United States v. Brooks, 681 F.3d 678, 691–692 (5th Cir. 2012) (also holding that "report" as used in section 9(a)(2) of the Act is not limited to official reports but rather applies to any reports containing information relating to matters that affect or tend to affect commodity pricing; upholding convictions for false reports relating to natural gas).

79.1 *See* § 1.02[12A][B] *infra*.

79.2 Section 1a(47)(A), 7 U.S.C. § 1a(47)(A), CCH Rep. ¶ 1002, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(21), Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010) and continues the distinction under prior law between security-based swaps that are subject to SEC jurisdiction. *See* Securities Exchange Act § 3(a)(68), 15 U.S.C. § 78c(a)(68).

79.3 Section 1a(47)(B), 7 U.S.C. § 1a(47)(B), CCH Rep. ¶ 1002, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(21), Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010). The legislative history makes clear that this exclusion was designed to parallel the pre-existing exclusion of forward contracts exclusion in the CEA and the CFTC's policy on forward contracts. The Act also excludes from the definition swap options and other contracts based on securities indexes where the option or contract is subject to SEC jurisdiction, as well as options and derivatives of individual securities as well as a carve-out for security-based swaps.

79.4 7 U.S.C. § 1b, CCH Rep. ¶ 1003.

80 *See also* the discussion *infra* §1.02[8] (the deterioration of the contract market monopoly), §4.05[8] (challenges to the Commission's jurisdiction), § 4.05[9][A] (ongoing jurisdictional assaults), and § 4.05[9][B] (reflections on CFTC/SEC jurisdiction).

81 Securities Act of 1933 §2A, Securities Exchange Act of 1934 §3A, 15 U.S.C. §§77b-1, 78c-1.

82 15 U.S.C. §§77b(a)(1), 78c(a)(10).

83 *E.g.*, 15 U.S.C. §§77q(a), 78j(b).

84 *See* Gramm-Leach-Bliley Act, Pub. Law. 106-102, 1999 U.S.C.C.A.N. (113 Stat.) 1338 (1999). *See generally* Symposium, 4 N.C. Banking Inst. 1 (2000); Michael K. O'Neal, Summary and Analysis of the Gramm-Leach-Bliley Act, 28 Sec. Reg. L.J. 95 (2000).

85 *See* Gramm-Leach-Bliley Act, Pub. Law. 106-102 sec. 206 (1999).

86 7 U.S.C. §27a, CCH Rep. ¶ 1921, CFMA § 403.

87 Section 2(f)(2), 7 U.S.C. 2(f)(2), CCH Rep. ¶ 1026, CFMA §105.

88 7 U.S.C. §27e, CCH Rep. ¶ 1925, CFMA § 407.

89 7 U.S.C. §27(d), CCH Rep. ¶ 1920, CFMA §402(d).

90 7 U.S.C. §16(e)(2), CCH Rep. ¶ 1371 (as amended by CFMA §117, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)).

90.1 For further discussion, *see* 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §§ 1:38-1:79 (7th ed. 2016). Some of the discussion that follows is adapted from there.

90.2 *See, e.g.,* section 2(a)(1) of the Securities Act of 1933, 15 U.S.C. § 77b(a)(1) ; 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation § 1.6 (6th ed. 2009).

90.3 *See, e.g.,* SEC v. W.J. Howey Co., 328 U.S. 293, 298–99, 66 S. Ct. 1100, 1102–03, 90 L. Ed. 1244 (1946); SEC v. The Infinity Group Co., 212 F.3d 180 (3d Cir. 2000), *aff'g* 993 F. Supp. 321, 993 F. Supp. 324 (E.D. Pa. 1998) (finding an investment contract based on pooling of investments where investors were promised fixed return); SEC v. Eurobond Exchange, Ltd., 13 F.3d 1334 (9th Cir. 1994) (finding common enterprise sufficient to make Eurobond investment program a security); In the Matter of ABC Portfolio Development Group, Inc., [1994–1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,422 (SEC 1994) (sales of investment pool interests were sales of interests in an investment company subject to the Investment Company Act of 1940 and also were securities subject to the 1933 and 1934 Acts).

90.4 Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996) (interest rate swaps lacked commonality and thus were not investment contracts). *Compare, e.g.,* County of Orange v. Fuji Securities, Inc., 31 F. Supp. 2d 768 (C.D. Cal. 1998) (securities repurchase agreement set up as a reverse repurchase (or repo) agreement is a security). *See also* Lehman Bros. Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159 (S.D.N.Y. 2001) (foreign currency swap was not a security under New York's Martin Act).

90.5 The definition of security requires that the profit on the investment be derived substantially from the efforts of others. However, this means more than pre-transaction efforts (in designing the investment) and some post transaction efforts in facilitating a secondary market. *See* SEC v. Life Partners, Inc., 87 F.3d 536 (D.C. Cir. 1996), *reh'g denied,* 102 F.3d 587 (D.C. Cir. 1996) (holding that viatical settlements were not securities). The court indicated that to find a security, the efforts of others must be significant in the success of the underlying investment and thus pre-marketing efforts are not to be given much weight. *Cf.* K3C Inc. v. Bank of America, N.A., 204 Fed. Appx. 455, 465 (5th Cir. 2006) (interest rate swaps were not securities under the Texas Securities Act), relying on Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1277–83 (S.D. Ohio 1996) and Lehman Bros. Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 164, 167 (S.D.N.Y. 2001).

90.6 The transaction was in a complex swap arrangement designed to simulate the effects of owning the stock of specified companies. As summarized by the court:

> According to Citibank's representations to Caiola, synthetic trading permits an investor to approximate large positions in securities without having to meet margin requirements, risk affecting a stock's value by making a large trade, risk not being able to find a seller or buyer when trying to establish or unwind a large position, or pay for or receive actual stock. Pursuant to their contract, each party is a principal in the transaction, and neither acts as the other's agent. [The parties] signed the standard form contract that would govern the synthetic transactions, called an International Swap Dealers Association Master Agreement ("ISDA Agreement").

Caiola v. Citibank, N.A., 137 F. Supp. 2d 362, 364 (S.D.N.Y. 2001) *rev'd,* 295 F.3d 312 (2d Cir. 2002).

90.7 Caiola v. Citibank, N.A., 295 F.3d 312 (2d Cir. 2002), *rev'g* 137 F. Supp. 2d 362 (S.D.N.Y. 2001).

90.8 CFDs are regulated in the U.K. by the Financial Services Authority (FSA) under the UK Financial Services and Markets Act of 2000. *See generally* FSA Publication: Disclosure of Contracts for Difference: Consultation and Draft Handbook (2007), available at http//www.fsa.gov.uk/pubs/cp/cp07_22.pdf ; "Contracts for Difference Introduction," available at http://www.contracts-for-difference.com/contracts-for-differences.html.

90.9 Freudenberg v. E*Trade Financial Corp, 2008 WL 2876373 (S.D.N.Y. July 17, 2008) (order certifying lead plaintiff and lead counsel). The citation to the Freudenberg case is 2008 WL 2876373. *Accord* In re Crocs Securities Litigation, 2008 WL 4298316 (D. Colo. 2008) (CFDs are securities and holders of CFDs were appointed as lead plaintiffs in securities fraud action). *See also* Thomas Lee Hazen, Derivatives, Unintended Consequences and the Securities Laws–Some Recent Developments, 28 Futures & Derivatives Law Report 1 (Issue 9, October 2008).

90.10 Pub. Law No. 106–554, 114 Stat. 2763 (Dec. 21, 2000).

90.11 *See* 15 U.S.C. §§ 77b–1(b)(1), 78c–1(b)(1) (excluding "security-based swap agreements" from the definition of "security"); 15 U.S.C.A. §§ 77b–1(a), 78c–1(a) (excluding "non-security-based swap agreements" from the definition of "security"). *See also* 15 U.S.C.A. §§ 77b(a)(1), 78c(a)(10) (definition of security); 15 U.S.C. §§ 77q(a), 78i(a), 78j(b) (antifraud and manipulation provisions). *See* Caiola v. Citibank, N.A., 137 F. Supp. 2d 362 (S.D.N.Y. 2001), *rev'd on other grounds,* 295 F.3d 312 (2d Cir. 2002) (refusing to give retroactive effect to CFMA's including synthetic trading agreement as a securities based swap agreement subject to the securities laws antifraud provisions), *rev'd*, 295 F.3d 312 (2d Cir. 2002) (holding that synthetic cash-settled options are securities).

90.12 Integrated Research Services, Inc. v. Illinois Secretary of State, Securities Dept., 328 Ill. App. 3d 67, 262 Ill. Dec. 304, 765 N.E.2d 130 (2002) (foreign currency contracts were held to be securities under the Illinois Securities Act).

90.13 *See* Henry T.C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008); Henry T. C. Hu & Bernard Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. Corp. Fin. 343 (2007); Henry T.C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011 (2006); Henry T.C. Hu & Bernard Black, Empty

Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 79 S. Cal. L. Rev. 811 (2006). This has been referred to as "empty voting." *Id.*

90.14 2008 WL 2372693 (S.D.N.Y. 2008).

90.15 15 U.S.C. § 78m(d).

90.16 The court in *CSX* made this finding notwithstanding the defendant hedge funds' argument that as holders of swaps, they lacked voting power with respect to the shares. The court did not reach the question of whether in other cases the absence of voting power would defeat a section 13(d) filing obligation since, per Rule 13b-3(b) (17 C.F.R. § 240.13d-3(b)) the court found a scheme to evade compliance with the filing requirement. CSX Corp. v. The Children's Investment Fund Management (UK) LLP, 2008 WL 2372693 (S.D.N.Y. 2008) ("Rule 13d-3(b) under the Exchange Act provides in substance that one who creates an arrangement that prevents the vesting of beneficial ownership as part of a plan or scheme to avoid the disclosure that would have been required if the actor bought the stock outright is deemed to be a beneficial owner of those shares. That is exactly what the defendants did here in amassing their swap positions. In consequence, defendants are deemed to be the beneficial owners of the referenced shares.").

90.17 Pub. Law No. 109-058 (Aug. 8, 2005).

90.18 In the Matter of Amaranth Advisors LLC, FERC Docket No. IN07-26-000, 120 FERC¶61,085, 2007 WL 2153253 (FERC July 26, 2007).

90.19 In the Matter of Amaranth, available at https://www.ferc.gov/sites/default/files/2020-05/128FERC61154.pdf (FERC Sep. 6, 2020).

90.20 *Brian Hunter*, 135FERC61,054 (Apr. 21, 2011) (Affirming Order).

90.21 Hunter v. FERC, 711 F.3d 155 (D.C. Cir. 2013).

90.22 *Id.*

90.23 CFTC v. Amaranth, 2009 U.S. Dist.LEXIS101406 (S.D.N.Y. Aug. 12, 2009).

90.24 CFTC v. Hunter, 2012 U.S. Dist. LEXIS 12384 (S.D.N.Y. Jan. 30, 2012).

90.25 *See* CFTC Press Rel. No. 5503-08, CFTC Announces Multiple Energy Market Initiatives, available at https://www.cftc.gov/PressRoom/PressReleases/5503-08? (CFTC May 29, 2008).

90.26 Pub. Law No. 110-140; *see* section 811 of Subtitle B of Title VIII of EISA, 42 U.S.C. §§17301–17305.

90.27 17 C.F.R. §240.10b-5. For a thorough discussion of Rule 10b-5, *see* 3–4 Thomas Lee Hazen, Treatise on the Law of Securities Regulation chapter 12 (7th ed. 2016).

90.28 Prohibitions on Market Manipulation and False Information in Subtitle B of Title VIII of The Energy Independence and Security Act of 2007, 73 Fed. Reg. 48317-01, 2008 WL 3833333 (proposing rules 16 C.F.R. §§317.1–317.5), available at https://www.ftc.gov/sites/default/files/documents/federal_register_notices/prohibitions-market-manipulation-and-false-information-subtitle-b-title-vii-energy-independence-and/081908marketmanip.pdf. *See* FTC News Release, FTC Seeks Comments on Proposed Rule Prohibiting Petroleum Market Manipulation, available at http://www.ftc.gov/opa/2008/08/nprm.shtm (Aug. 13, 2008).

90.29 *Id.*

90.30 *Id.*

90.31 Author Johnson has been recognized as the principal proponent for CFTC exclusive jurisdiction at the time of its formation and admits to a bias on the subject. See *Agents of Change*: Futures Magazine at 16–17 (Special Issue 2007).

90.32 Dodd-Frank Wall Street Reform and Consumer Protection Act §720, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010).

90.33 Memorandum of Understanding Between the Federal Energy Regulatory Commission and the Commodity Futures Trading Commission (Jan. 2, 2014).

90.34 *Id.*

90.35 CFTC Press Rel. No. 6873-14, CFTC, FERC Implement Information Sharing MOU, available at http://www.cftc.gov/PressRoom/PressReleases/6873-14 (CFTC Mar. 5, 2014).

90.36 *Id.*

90.37 Final Order in Response to a Petition From Certain Independent System Operators and Regional Transmission Organizations to Exempt Specified Transactions Authorized by a Tariff or Protocol Approved by the Federal Energy Regulatory Commission or the Public Utility Commission of Texas From Certain Provisions of the Commodity Exchange Act Pursuant to the Authority Provided in the Act, 78 Fed. Reg. 19880 (CFTC Apr. 2, 2013).

90.38 Order Exempting, Pursuant to Authority of the Commodity Exchange Act, Certain Transactions Between Entities Described in the Federal Power Act, and Other Electric Cooperatives, 78 Fed. Reg. 19670 (CFTC Apr. 2, 2013).

91 *See, e.g.*, sections 1a (7 U.S.C. §la), 4a(a) (7 U.S.C. 6a(a)), 4b (7 U.S.C. §6b), 4d (7 U.S.C. §6d), 4e (7 U.S.C. §6e), 5(b)(3) (7 U.S.C. §7(b)(3)). The Act, however, also uses phrases such as "purchase or sale of any commodity for future delivery" (*see, e.g.*, section 4d, 7 U.S.C. §6d) and "contract for future delivery" (*see, e.g.*, section 4b, 7 U.S.C. §6b).

92 *See supra* §1.02[2].

93 7 U.S.C. §la, CCH Rep. ¶ 1011.

94 *Id.* In determining whether a contract is a futures contract, "no brightline definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye toward its underlying purpose." CFTC v. Co Petro Marketing Group, 680 F.2d 573, 581 (9th Cir. 1982).

In In re Bybee, 94F.2d 309, 314-315 (9th Cir. 1991), the Ninth Circuit explained that when delivery is contemplated but the obligation is deferred because of commercial convenience or necessity, the forward contract exclusion will be applied. The court in so ruling deferred to the Commission's position as announced in its statutory interpretation. *See* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,718 (CFTC Sept. 30, 1985). *See also, e.g.*, Parrott v. Monex Int'l, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,167 (CFTC Initial Dec. 1991) (cash transaction was not subject to regulation as a futures contract); CFTC Interpretative Ltr. No. 95-104, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,592 (CFTC Off-Exchange Task Force Nov., 1995) (live hog contracts were forward not futures contracts).

In 1990, the Commission relied on the forward contract exclusion to permit off-exchange trading of North Sea oil contracts. *See* Statutory Interpretation Concerning Forward Contracts, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925 (CFTC Sept. 25, 1990). This interpretation was not without controversy. *See, e.g.*, Brent Oil Interpretation Is Change From Existing Law, CFTC's West Contends, 22 Sec. Reg. & L. Rep. (BNA) 1693 (Dec. 7, 1990). Subsequently, a divided Commission approved an exemption for qualifying energy product contracts. *See* Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, (1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,633 (CFTC Apr. 20, 1993). *See also infra* § 1.02[5].

However, in contrast to the Ninth Circuit's 1991 ruling in *Bybee*, In re Bybee, 945 F.2d 309, 314-315 (9th Cir. 1991), *supra*, the Ninth Circuit in CFTC v. Noble Metals Int'l, Inc. 67 F.3d 766 (9th Cir. 1995) [27 BNA 1619], held that a so-called "forward delivery program" involved futures not forward contracts. Unlike the situation in *Bybee*, the court in *Noble Metals* found that it was not contemplated that the customers would take delivery and, therefore, the transactions involved "futures" rather than "forward" contracts. The court also noted that a transfer of title to the underlying commodities did not in itself satisfy the delivery requirement.

95 *See* 7 U.S.C. §1a, CCH Rep. ¶ 1011.

96 Nagel v. ADM Inv. Serv., Inc., 217 F.3d 436, 441 (7th Cir. 2000).

97 It is clear that designation does not dictate whether a contract is a forward or a futures contract. In the Matter of First Nat'l Monetary Exch., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985).

In determining whether a contract for delayed delivery is a futures contract, a number of factors come into play. Standardization of terms is a key feature of publicly traded futures contracts. With a futures contract most customers do not expect to take delivery and probably lack the facilities to do so. *See, e.g.*, Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1157 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003) (futures contracts generally do not contemplate or result in physical transfer of underlying commodity). There is an opportunity to offset, and the customer has a right to liquidate rather than take delivery. Another indicia of a futures contract is that the commodity generally has no business use for the customer but rather is traded for profit. The customer can take a long or a short position and controls the position in a futures contract with a partial deposit (margin). With a futures as opposed to a forward contract the customer does not acquire a specific right to a particular lot of the commodity. *See infra* § 1.02[5].

It has been suggested that two interpretations by the Office of General Counsel of the CFTC indicate that the traditional factors may eventually yield to an inquiry as to whether or not delivery is required and ordinarily occurs as matter of course under a particular type of contract. OGC Interpretation, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,518 (March 25, 1985); OGC Interpretative Ltr. No. 852, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (Aug. 6, 1985). *See* Gilberg, Regulation of New Financial Instruments Under the Federal Securities and Commodities Laws, 39 Vand. L. Rev. 1599, 1607-1608 (1986). *See also, e.g.*, for the Commission's narrow interpretation of this exclusion, its proposal to regulate leverage contracts as futures at 44 Fed. Reg. 13,494, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772 (March 12, 1979). *See also* In re Stovall, [1977-1980 Transfer Binder] Conmr. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979).

98 *See infra* §1.02[7].

98.1 *Cf.* Andrew A. Schwartz, Consumer Contract Exchanges and the Problem of Adhesion, 28 Yale J. Reg. 313 (2011) (contending that adhesion contract principles should not apply to enforcement of exchange traded standardized contracts).

99 Standardized terms preclude negotiation of the mechanics of the transaction and facilitate efficient public trading. *See* CFTC v. Co Petro Marketing Group, 680 F.2d 573 (9th Cir. 1982) ; NRT Metals v. Manhattan Metals, 576 F. Supp. 1046 (S.D.N.Y. 1983) ; Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982) ; Habas v. American Board of Trade, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,500 (CFTC 1987) ; In the Matter of First Nat'l Monetary Exch. [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985) ; Jones v. First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,740 (CFTC 1983) ; CFTC v. Nat'l Coal Exch., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,421 (CFTC 1982) ; In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979), *aff'g id.* ¶ 20,420 (CFTC 1979).

100 Of course, because a number of different delivery months may be offered by the contract market (*e.g.*, January, March, May, July, September, or November), each trader must select the month of his choice. Once having done so, however, the trader is bound irrevocably to the terms of the futures contract applicable to transactions in the selected delivery month.

101 *See* In re Bybee, 945 F.2d 309, 312-313 (9th Cir. 1991). *See also, e.g.*, CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982).

102 In re Bybee, 945 F.2d 309, 313 (9th Cir. 1991).

103 *See, e.g.*, Parrott v. Monex Int'l, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,167 (CFTC Initial Dec. 1991).

104 *See, e.g.*, Bank Brussels Lambert, S.A. v. Intermetals Corp., 779 F. Supp. 741 (S.D.N.Y. 1991) (the Act was not implicated by a broker who allegedly induced a customer into rolling over his position by entering into one spot contract after another); Motzek v. Monex Int'l, Ltd., [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,728 (CFTC Initial Dec. 1993) (precious metals transactions more closely resembled

cash transactions). *See also, e.g.*, Ansari v. E.F. Hutton & Co., [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,668 (CFTC Initial Dec. 1993) (CFTC had no jurisdiction over FOREX foreign currency transactions). Cf CFTC Interpretative Ltr. No. 93-5, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,570 (CFTC Div. of Trading & Markets Jan. 27, 1993) (insufficient facts to determine whether the Act applied). *See* United States v. Reliant Energy Servs. Inc., 420 F. Supp.2d 1043, 1061–1062 (N.D. Cal.) (relying on this treatise), *aff'd in part*, 188 Fed. Appx. 629 (9th Cir. 2006).

105 *See* CFTC Interpretative Lit. No. 91-8, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,156 (CFTC Div. of Trading & Markets Oct. 9, 1991).

106 CFTC v. Dunn, 58 F.3d 50 (2d Cir. 1995), *rev'd*, 519 U.S. 465 (1997).

107 *Id.*

108 Salomon Forex, Inc. v. Tauber, 8 F.3d 966 (4th Cit. 1993), *cert. denied*, 114 S. Ct. 1540 (1994). *See infra* §§1.02[7], 4.05[7].

109 CFTC v. American Board of Trade, 803 F.2d 1242 (2d Cit. 1986).

110 Dunn v. CFTC, 519 U.S. 465 (1997).

111 The National Futures Association (NFA) adopted rules to protect retail customers in over-the-counter forex transactions. See CFTC and NFA Announce New Rules to Combat Fraud in the Retail Off-Exchange Forex Foreign Currency Market, CFTC 4833-03, 2003 WL 22007129 (CFTC News Release August 26, 2003). The NFA rules require member firms to take responsibility for the activities of these unregulated solicitors in retail over-the-counter forex transactions. The specific requirements imposed by the NFA rules include:

- observing high standards of commercial honor and just and equitable principles of trade in connection with the retail forex business;
- supervising their employees and agents and any affiliates that act as counterparties to retail forex transactions;
- maintaining a minimum net capital requirement based on the value of open customer positions; and
- collecting security deposits from those customers.

Id. The NFA also prepared an Investor Alert highlighting some of the risks involved in retail off-exchange forex trading as well as an educational brochure so that retail forex customers may be able to make informed decisions, as well as a regulatory guide to help its forex member firms understand their regulatory responsibilities.

112 Section 2(c), 7 U.S.C. §2(c), CCH Rep. ¶ 1023.

113 *Cf.* BP North American Petroleum v. Solar ST, 250 F.3d 307, 311 (5th Cir. 2001) (discussing the difference between hedging and speculation):

> BP was a hedger in the futures market, not a speculator, as the district court asserted in its opinion. BP's actions were designed only to protect itself from financial loss after AHL contaminated the diesel oil. Had BP not hedged its position, and the price of oil had dropped twenty percent pending disposition, BP would have lost considerable money by retaining the oil while the price fell. As a hedger, BP could not have "profited" from its futures trading, as the district court suggests, in the sense that any money made in futures trading would have been offset by an equivalent fall in the price BP received for the contaminated oil on the date of disposal.

(footnote omitted). The court went on to hold that since the futures trading were legitimate hedging transactions, they were irrelevant in calculating damages for breach of contract based on contamination of fuel oil.

114 Section 2(a)(1)(C)(ii), 7 U.S.C. §2(a)(1)(C)(ii), CCH Rep. ¶ 1011A.

115 Board of Trade of the City of Chicago v. Christie Grain & Stock Co., 198 U.S. 236 (1905) ; Lyons Milling Co. v. Goffe & Carkener, 46 F.2d 241 (10th Cir. 1931) ; Palmer v. Love, 80 S.W.2d 100 (Tenn. 1934).

116 Proposed Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise, 44 Fed. Reg. 13,494, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at p.23,164 (CFTC March 12, 1979). The Commission de-emphasized the frequency of delivery in favor of whether each party can legally compel delivery.

117 A transaction involving delayed delivery at the market price is more in the nature of a spot transaction and will not be deemed a futures contract and thus will not implicate the Commission's jurisdiction. *See, e.g.*, CFTC v. Zelener, 2003 WL 22284295 *4 (N.D. Ill. 2003) ; CFTC v. Frankwell Bullion Ltd, 1994 WL 449071 (N.D.Cal. 1994). The Zelener decision was affirmed. CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) (rollovers of foreign currency transactions were not "contracts of sale of a commodity for future delivery," and dealer's promise did not create futures contract).

118 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979), aff'g ¶ 20,420 (CFTC 1979). *See also, e.g.*, CFTC v. Co Petro Marketing Group, 680 F.2d 573 (9th Cir. 1982), aff'g 502 F. Supp. 806 (C.D. Cal. 1980).

119 The statute was subsequently rewritten to make clear its applicability to privately created contracts. *See* 7 U.S.C. §6, CCH Rep. ¶ 1035.

120 *See infra* §1.02[7].

121 7 U.S.C. §la, CCH Rep. ¶1011. *Cf., e.g.*, Linkenhoger v. Monex Int'l, 20 Sec. Reg. & L. Rep. (BNA) 310 (CFTC 1988) (sale of silver at fixed price with delayed delivery was neither a futures contract nor a leverage transaction).

122 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979).

123 *Id.* ¶ 20,941, at 23,778.

124 *Id.* at 23,779.

125 *Id.*

126 *Id.* at 23,779-23,781.

127 *Id.* at 23,781.

128 *Id.*

129 The current version is found in 7 U.S.C. §6h, CCH Rep. ¶ 1111.

130 Galvin v. First Nat'l Monetary Corp., 624 F. Supp. 154 (E.D.N.Y. 1985) (whether "cash forward contract" was in fact a futures contract held to be a triable question of fact). *See* Fitch v. Spiegel, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,327 (CFTC 1988) (bank-financed precious metals contract was a forward contract, and thus the Commission lacked jurisdiction), relying on Office of General Counsel Interpretation 85-2, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (Aug. 6, 1985). *See also, e.g.*, First Nat'l Monetary Corp. v. CFTC, 860 F.2d 654 (6th Cir. 1988) (CFTC claim that bullion "cash forward" contracts were in fact illegal futures contracts was "substantially justified" thus precluding trader who was named as defendant from obtaining attorney's fees under the Equal Access to Justice Act). *See also, e.g.*, In the Matter of First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985).

Compare Transnor (Bermuda) Ltd. v. BP N. Am. Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990) (denying summary judgment; transactions entered into for the purpose of shifting price risk without transferring the underlying commodity were not forward contracts and thus were contracts for future delivery within the Act). The Commodity Exchange Act claims that survived the motion for summary judgment in *Transnor* were subsequently settled. At issue in *Transnor* were off-exchange contracts calling for fifteen-day delivery of Brent Oil. The contracts did not specify a particular date; instead, a month was designated and the party delivering the oil was required to give fifteen days' notice before delivery could take place. The court's decision that these were futures contracts subject to CFTC jurisdiction was based on the perceived speculative and hedging purposes of the contracts. The ruling on defendant's motion for summary judgment created a great deal of uncertainty for oil companies. The Commission's General Counsel responded with a statutory interpretation to the effect that such contracts are forward, rather than futures, contracts; the interpretation was approved by the Commission. [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925 (Sept. 25, 1990). *See also* 22 Sec. Reg. & L. Rep. (BNA) 955 (June 22, 1990). As is the case with other forward contracts, these oil agreements include a specific delivery obligation and a significant economic risk that the purchaser will be required to take delivery but the Commission's analysis took on importance because, notwithstanding the contracts' legal terms, actual delivery (exception paper) was infrequent. The Commission's use of this forward contract rationale, according to one Commissioner, is not a clarification but rather "is a significant change" from existing law. 22 Sec. Reg. & L. Rep. (BNA) 1693 (Dec. 7, 1990) (Comments of Commissioner West).

In 1993, the Commission issued an order that grants an exemption for qualifying energy product contracts. *See* Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,633 (CFTC Apr. 20, 1993). Under the terms of the order, which was issued pursuant to the exemptive authority granted by the Futures Trading Practices Act of 1992, certain contracts for deferred delivery of crude oil, condensates, natural gas, natural gas liquids, or derivatives used primarily as an energy source are exempt. The exemption is only available for contracts between commercial participants. These commercial participants must have the capacity to carry out their delivery (or receipt) obligations under the contract. The transaction must create legally binding delivery rights and obligations and, while a subsequent settlement in cash does not destroy the exemption, it must not have been provided for initially and either party must be free to refuse its substitution. In order to qualify to participate in an exempt transaction, a party must not have been formed solely for the purpose of taking advantage of the exemption. Additionally each party must be either a commercial participant or a government agency or entity. There are additional qualifications for commercial participants. A qualified commercial participant must be (i) a bank or trust company; (ii) a business entity with a net worth in excess of $5 million or total assets of more than $10 million (or where the obligations are guaranteed by a letter of credit from an entity satisfying the minimum worth requirements or an entity identified in sections 4(c)(3)(A), (B), (C), (H), (I), or (J) of the Act, 7 U.S.C. §§6(a)(c)(3)(A), (B), (C), (H), (I), or (J), CCH Rep. ¶ 1035 (banks, trust companies acting in a fiduciary capacity, savings associations, insurance companies, governmental entities and subdivisions, registered securities, and commodities professionals). As is the case with the exemption for swap transactions, the exemption for qualified energy product contracts remains subject to the Act's antimanipulation provisions or to the jurisdictional provisions of section 2(a)(I)(B), although exemption is provided from the section 4b and section 4o antifraud provisions.

In CFTC v. Noble Metals Int'l, Inc., 67 F.3d 766 (9th Cir. 1995), held that a so-called "forward delivery program" involved futures, not forward, contracts. Unlike the situation in *Bybee*, the court in Noble Metals found that it was not contemplated that the customers would take delivery and, therefore, the transactions involved "future" rather than "forward" contracts.

131 NRT Metals v. Manhattan Metals, 576 F. Supp. 1046 (S.D.N.Y. 1983) ; Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982) ; Flabas v. American Bd. of Trade, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,500 (CFTC 1987) ; In the Matter of First Nat'l Monetary Exchange, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,698 (CFTC 1985) ; Jones v. First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,740 (CFTC 1983) ; CFTC v. National Coal Exch., [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,421 (CFTC 1982) ; In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979), *aff'g id.* ¶ 20,420 (CFTC 1979). *Accord, e.g.*, CFTC v. American Metal Exch. Corp., 693 F. Supp. 168 (D.N.J. 1988) ; In the Matter of Schierl, 1988 CFTC LEXIS 504 (CFTC 1988).

132 CFTC v. Co Petro Marketing Group, 680 F.2d 573 (9th Cir. 1982) ; Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1157 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003).

Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982) ; In the Matter of First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,698 (CFTC 1985).

133 CFTC v. Co Petro Marketing Group, 680 F.2d 573 (9th Cir. 1982).

134 Jones v. First Nat'l Monetary Corp., [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,740 (CFTC 1983).

135 Morgan v. State of Texas, [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,601 (Tex. Ct. App. 1982).

136 NRT Metals v. Manhattan Metals, 576 F. Supp. 1046 (S.D.N.Y. 1983) ; Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982).

137 Of the cases cited above, all but one found the contracts in question to be futures contracts. The exception was designated a leverage contract. In the Matter of First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,836 (CFTC 1985). Leverage contracts are discussed infra §§1.02[11], 1.13. *See also, e.g.*, Gerstell, Developments in Off Exchange Financial Products, 21 Rev. Sec. & Comm. Reg. I (1988).

138 *See supra* §1.02[3].

139 CFTC v. Co Petro Marketing Group, 680 F.2d 573, 581 (9th Cir. 1982) ("The transaction must be viewed as a whole with a critical eye toward its underlying purpose. The contracts here represent speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation"). CFTC v. Hanover Trading Corp., 34 F. Supp. 2d 203 (S.D.N.Y. 1999) (contracts where no delivery was contemplated were futures contracts); In re Grain Land Cooperative, 30 Sec. Reg. & L. Rep. (BNA) 1714 (CFTC Initial Dec. 1998) ("flexi" hedge-to-arrive contracts were not forward contract and thus were subject to CFTC jurisdiction where, among other things, there was no "forced burden of delivery"); In re The Anderson's Inc., 30 Sec. Reg. & L. Rep. (BNA) 72 (CFTC 1998) (grain elevator settled charges that it entered into illegal hedge-to-arrive contracts that were futures rather than forward contracts because producers routinely avoided the delivery obligation). *Compare, e.g.*, In re Bybee, 945 F.2d 309 (9th Cir. 1991), *aff'g* Krommenhoek v. A-Mark Precious Metals, Inc., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,952 (D. Idaho 1990) (delayed delivery on margin purchases of precious metals did not result in a futures contract since purchasers believed that delivery would be forthcoming).

140 In re Bybee, 945 F.2d 309 (9th Cir. 1991). But the manipulation prohibitions of the Act continue to apply. Section 9(a), 7 U.S.C. §13, CCH Rep. ¶ 1341. Manipulation is discussed *infra* Chapter 5.

141 In re Bybee, 945 F.2d 309 (9th Cir. 1991). The court in *Bybee* reached its conclusion by deferring to the Commission. *See* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,718 (CFTC Sept. 30, 1985). *See also* Abels v. Farmers Commodities Corp., 259 F.3d 910, 917 (8th Cir. 2001) (whether hedge-to-arrive contracts are futures contracts or forward contracts depends on whether parties intended actual delivery). In contrast, where it is contemplated that the investor will not take delivery, a futures contract will be found. *See* CFTC v. Noble Metals Int'l, Inc., 67 F.3d 766 (9th Cir. 1995).

A showing of isolated deliveries is insufficient to prove that the forward contract exclusion applies. CFTC v. IBS, Inc., 113 F. Supp. 2d 830, 847 (W.D.N.C. 2000). However, the mere right to extend the delivery date does not convert a forward contract into a futures contract. In re Robinson, 265 B.R. 722, 730 (Bankr. 6th Cir. 2001); Blanchard Valley Farmers Cooperative, Inc. v. Carl Niese & Sons Farms, Inc., 143 Ohio App. 3d 795, 800, 758 N.E.2d 1238, 1242 (2001).

142 In re Bybee, 945 F.2d at 315. The fact that delivery was due on demand made it appear as if any deferring of delivery was due to commercial convenience.

143 Bank Brussels Lambert, S.A. v. Intermetals Corp., 779 F. Supp. 741 (S.D.N.Y. 1991) (the Act was not implicated by a broker who allegedly induced a customer into rolling over his position by entering into one spot contract after another). However, the CFTC has taken the view that such "rolling spot" contracts are futures. The fact that the price specified in the contract is within a range and thus not set until actual delivery does not preclude a determination that there is a forward rather than a futures contract. *See* CFTC Interpretative Ltr. No. 98-13, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,264 (CFTC Div. of Trading & Markets Dec. 3, 1997) (both parties were commercial participants and the contract contained binding unalterable delivery obligations).

144 *Id. See also* Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1157 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003) (court should consider intentions of parties, terms of contract, course of dealing between parties, and any other relevant factors). *Compare, e.g.,* CFTC v. Calvary Currencies, LLC, 437 F. Supp. 2d 453 (D. Md. 2006) (foreign currency transactions were futures transactions rather than spot transactions; defendant was a counterparty to a futures transaction and thus subject to CFTC jurisdiction in an action claiming defendant engaged in illegal off-exchange futures transactions) *with* CFTC v. Erskine, 512 F.3d 309 (6th Cir. 2008) (foreign currency transactions were forward contracts rather than futures contracts as had been urged by the CFTC) *and* CFTC v. Uforex Consulting, LLC, 551 F. Supp. 2d 513 (W.D. La. 2008) (rejecting CFTC's position and finding that foreign currency transactions were not futures contracts subject to CFTC jurisdiction).

145 *See, e.g.*, Gunderson v. ADM Investor Services, Inc., 85 F. Supp.2d 892 (N.D. Iowa), *reversed on other grounds*, 2000 WL 1154423, 230 F.3d 1363 (8th Cir. 2000) (unpublished opinion) (fact findings were required to determine whether hedge-to-arrive contract was a futures or a forward contract); Galvin v. First Nat'l Monetary Corp., 624 F. Supp. 154 (E.D.N.Y. 1985) (denying defendant's motion for summary judgment).

146 In the Matter of First Nat'l Monetary Corp., [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,836 (CFTC 1985). *See also, e.g.*, Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955, 964-965 (D.N.J. 1982) (finding "cash forward" contract to be illegal futures contract rather than legitimate leverage contract). *See also, e.g.*, DuBois v. Alaron Trading Corp., [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28406 (CFTC 2000), *aff'g* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,061 (CFTC Initial Dec. 1997) (leverage contracts involving foreign currency could not be sold to unsophisticated investors in off-exchange transactions).

147 *See infra* §§1.02[11], 1.13. *See* CFTC v. P.I.E., Inc., 853 F.2d 721 (9th Cir. 1988) (purported leverage contracts with durations of less than ten years were futures contracts rather than subsets of leverage contracts that were left unregulated by the Commission; because these contracts were sold in off-exchange transactions, they violated the Act's contract market monopoly for futures contracts).

148 *See* United States v. Bein, 728 F.2d 107 (2d Cir. 1984) ; Precious Metals Assocs. v. CFTC, 620 F.2d 900 (1st Cir. 1980), *aff'g* [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,882 (CFTC 1979); CFTC v. United States Metals Depository Co., 468 F. Supp. 1149 (S.D.N.Y. 1979).

149 *See infra* §§1.12[1] - 1.12[4].

150 *See* §4c(d), 7 U.S.C. §6c(d), CCH Rep. ¶ 1064 (dealer options); 17 C.F.R. Pt. 30, CCH Rep. ¶¶ 2701-2730 (foreign options); 17 C.F.R. §32.4(b), CCH Rep. ¶ 2724 (general exemptive power).

151 Hamilton West Dev., Ltd. v. Hills Stores Co., 959 F. Supp. 434 (N.D. Ohio 1997) (unlimited rollover feature precluded defendant's motion for summary judgment that hedge-to-arrive contracts were not futures contracts). *But cf.* North Central F.S., Inc. v. Brown, 951 F. Supp. 1383 (N.D. Iowa 1996) (defense to common law breach of contract action based on illegality under Commodity Exchange Act of off-exchange hedge-to-arrive contracts could not support federal jurisdiction under "well pleaded complaint rule").

The Commission issued a policy statement indicating that only limited rollover provisions would be prudent in off-exchange hedge-to-arrive contracts. Division of Economic Analysis Statement of Policy in Connection with the Unwinding of Certain Existing Contracts for the Delivery of Grain and Statement of Guidance Regarding Certain Contracting Practices, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. ¶ 26,691 (CFTC Div. of Economic Analysis May 15, 1996). Specifically, the Commission announced its position that the exclusion for forward contracts could be jeopardized by anything beyond sequential rolling out of contracts to a different price within the same crop year. *Id. See* CFTC's Division of Economic Analysis Issues Statements of Policy and Guidance Relating to Hedge-to-Arrive Contracts, 1998 WL 253833 (May 15, 1996); Comm Fut. L. Rep. (CCH), Report Bull. No. 528 (June 7, 1996).

See also, e.g., MG Ref. & Mktg. Inc. v. Knight Enters. Inc., 25 F. Supp. 2d 175 (S.D.N.Y. 1998) ("flexie" contracts allowing buyers to specify delivery terms after contracts were executed were not forward contracts); In re Grain Land Coop., 30 Sec. Reg. & L. Rep. (BNA) 1714 (CFTC Initial Dec. 1998) ("flexi" hedge-to-arrive contracts were not forward contracts and thus were subject to CFTC jurisdiction where, among other things, there was no "forced burden of delivery"); In re The Anderson's Inc., 30 Sec. Reg. & L. Rep. (BNA) 72 (CFTC 1998) (grain elevator settled charges that it entered into illegal hedge-to-arrive contracts that were futures rather than forward contracts because producers routinely avoided the delivery obligation). *Cf.* Cary Oil Co. v. MG Refining & Marketing, Inc., 230 F. Supp.2d 439 (S.D.N.Y. 2002) ("Flexie" long term fixed price petroleum supply contracts were not trade options).

152 *See, e.g.*, Top of Iowa Cooperative v. Schewe, 324 F.3d 627 (8th Cir. 2003), *aff'g* 6 F. Supp. 2d 843 (N.D. Iowa 1998) (hedge-to-arrive contracts were forward contracts); In re Robinson, 265 B.R. 722, 730 (Bankr. 6th Cir. 2001) (seller's option to roll forward original delivery date to future (but definite) date did not convert hedge-to-arrive contract into futures contract); Nagel v. ADM Inv. Serv., Inc., 217 F.3d 436, 441 (7th Cir. 2000) (eventual delivery was reasonably assured); Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777 (7th Cir 1999), *aff'g* 26 F. Supp. 2d 1107 (N.D. Ind. 1998) (grain contracts were forward contracts); Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308 (6th Cir. 1998) (hedge-to-arrive contracts were cash forward contracts and thus not subject to Commodity Exchange Act's arbitration provisions); Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1163-1165 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003) (hedge-to-arrive contracts that contemplated actual delivery of grain were forward contracts); Johnson v. Land O' Lakes, Inc., 18 F. Supp. 2d 985 (N.D. Iowa 1998) (hedge-to-arrive contracts were cash forward contracts not subject to CFTC regulation); Barn v. Geneva Elevator Co., 12 F. Supp. 2d 943 (N.D. Iowa 1998) (hedge-to-arrive contracts were forward contracts not subject to CFTC jurisdiction); The Andersons, Inc. v. Crotser, 7 F. Supp. 2d 931 (W.D. Mich. 1998) (hedge-to-arrive contracts were forward contracts and thus not subject to Commodity Exchange Act's arbitration provisions); Oehjenbrun v. CSA Investors, Inc., 3 F. Supp. 2d 1024 (N.D. Iowa 1998) (hedge-to-arrive contracts were cash forward contracts). In re Grain Land Coop. Cases, 29 Sec. Reg. & L. Rep. (BNA) 1385 (D. Minn. 1997); Sack Bros. v. Great Plains Co-op., Inc., 616 N.W.2d 796 (Neb. 2001) (finding HTA contracts to be forward contracts and enforceable under state law). *See also, e.g.*, Great Plains Coop. v. Amundson, 30 Sec. Reg. & L. Rep. (BNA) 1413 (D. Neb. 1998) (leaving open the delivery and destination terms did not prevent hedge-to-arrive contracts from qualifying as cash forward contracts because delivery was clearly contemplated); Jennifer Durham King & James J. Moylan, Hedge-to-Arrive Contracts: Jurisdictional Issues Under the Commodity Exchange Act, 18 N. Ill. U. L. Rev. 481 (1998); Glenn L. Norris, George F. Davison & David N. May, Hedge-to-Arrive Contracts and the Commodity Exchange Act: A Textual Alternative, 47 Drake L. Rev. 319 (1999); Note, Hedge-to-Arrive Contracts and the Commodity Exchange Act, 7 Kan. J.L. & Pub. Pol'y 122 (1998). CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) (foreign currency rollover contracts sales were forward contracts and thus not subject to the Act).

153 *See, e.g.*, In the Matter of Wright, 2003 CFTC Lexis 24 (CFTC 2003).

154 In the Matter of Wright, 2003 CFTC Lexis 24 (CFTC 2003).

155 *E.g.*, Gunderson v. ADM Investor Servs., Inc., 2001 U.S. Dist. LEXIS 3383, at *38-42 (N.D. Iowa 2001) (whether the HTAs constituted futures or forwards too fact intensive and could not be resolved in a motion to dismiss); Gunderson v. ADM Investor Servs., Inc., 85 F. Supp. 2d 892, 913 (N.D. Iowa 2000) (same).

156 Top of Iowa Cooperative v. Schewe, 324 F.3d 627 (8th Cir. 2003) (hedge-to-arrive contracts were forward contracts); Abels v. Farmers Commodities, Corp., 259 F.3d 910, 917 (8th Cir. 2001); Nagel v. ADM Investor Servs., Inc., 217 F.3d 436, 438-442 (7th Cir. 2000); Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983, 987, 996 (8th Cir. 1999); Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777, 785-90 (7th Cir. 1999); Haren

v. Conrad Coop., 198 F.3d 683, 683 (8th Cir. 1999); Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 317-22 (6th Cir. 1998); Asa-Brandt, Inc. v. ADM Investor Servs., Inc., 138 F. Supp. 2d 1144, 1165 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003); Patten Farms, 2000 U.S. Dist. LEXIS 21650, at *6-11(S.D. Iowa 2000); CoBank, ACB Corp. v. Alexander, Case No. 3:96CV7687, 1999 U.S. Dist. LEXIS 17288, at *30-31 (N.D. Ohio July 27, 1999) ; In re Gray, 252 B.R. 689, 698-700 (Bankr. S.D. Ohio 2000) (most, but not all, of the HTAs before it were forward contracts); Sack Bros. v. Great Plains Coop., Inc., 616 N.W.2d 796, 800-09 (Neb. 2000); Maynard Coop. Co. v. Recker, 2001 Iowa App. LEXIS 705, at *3-5 (Iowa Ct. App. 2001); Blanchard Valley Farmers Coop., Inc. v. Rossman, 761 N.E.2d 1156, 1161-62 (Ohio Ct. App. 2001); Blanchard Valley Farmers Coop., Inc. v. Carl Niese & Sons Farms, Inc., 758 N.E.2d 1238, 1242 (Ohio Ct. App. 2001); In the Matter of Wright, 2003 CFTC Lexis 24 (CFTC 2003) ; In the Matter of Grain Land Cooperative, CFTC Docket No. 97-01 November 25, 2003 CFTC No. 97-01, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636, 2003 WL 22803511 (CFTC 2003) (vacating ALJ's determination that HTAs were futures contracts).

157 As pointed out in In the Matter of Wright, 2003 CFTC Lexis 24 *46 (CFTC 2003) :

> [I]n terms of delivery contemplation, futures are better described as contracts as to which a critical mass of contract parties do not contemplate making or taking delivery. Conversely, forwards can be described as agreements concerning which a critical mass of contract parties contemplate making or taking delivery. Thus, when evaluating contracts as a class and looking to delivery contemplation, a small percentage of contract parties do not define the contract for all.

158 *See, e.g.*, In the Matter of Grain Land Cooperative, CFTC Docket No. 97-01 November 25, 2003 CFTC No. 97-01, [2003-2004 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 29,636, 2003 WL 22803511 (CFTC 2003). CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) (foreign currency rollover contracts sales were forward contracts and thus not subject to the Act).

159 *See* the discussion *infra* §1.02[8]. *See also supra* §1.02[2], *infra* §§4.05[2], 4.05[10].

160 *See, e.g.*, Kimberly D. Krawiec, More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives, 23 J. Corp. L. 1 (1997).

161 15 U.S.C. §77b(a)(1).

162 *See* 12 C.F.R. §204.2(c)(1).

163 *See* Statutory Interpretation Concerning Certain Hybrid Instruments, 54 Fed. Reg. 1139, [1987–1990 Transfer Binder] Comm. Fut. L. Rep. (CCI1) ¶ 24,379 (CFTC Jan. 11, 1989). *See also, e.g.*, CFTC Interpretative Ltr. No. 88-18, [1987–1990 “transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,321 (CFTC, Off-Exchange Task Force Sept. 23, 1988) (permitting bank to issue off-exchange certificates of deposit indexed in part to the spot price of gold); CFTC Interpretative Ltr. No. 88-15, 20 Sec. Reg. & L. Rep. (BNA) 1565 (CFTC avail. Sept. 28, 1988) (semble); CFTC Interpretative Ltr. 88-12, 20 Sec. Reg. & L. Rep. (BNA) 1249 (CFTC avail. July 22, 1988) (indicating that the CFTC staff would not take action against issuers of debt instruments having payments linked to the exchange rate between the dollar and foreign currencies); CFTC Interpretative Ltr. No. 88-10, 20 Sec. Reg. & I.. Rep. (BNA) 1106 (June 20, 1988) (permitting, without requiring registration, issuance of note the principal value of which was related to the dollar-yen exchange rate). Previously the CFTC had proposed regulating some of these hybrid debt or banking products, but this met with resistance from the SEC. *See* SEC Criticizes CFTC Draft Proposal to Extend Regulation to Flybrid Products, 20 Sec. Reg. & L. Rep. (BNA) 1348 (Aug. 26, 1988). *Cf.* Note, Bank-Financed Precious Metals Trading—Is It Just Another Precious Metals Scam?, 93 Dick. L. Rev. 107 (1988).

164 Specifically, to qualify for the exclusion, the hybrid debt or depository instrument must:

1. be indexed to a commodity on no greater than a one-to-one basis;
2. limit the maximum loss to the purchaser;
3. have a commodity-independent yield of at least 50 percent but no more than 150 percent of the estimated annual yield at the time of issue for a comparable nonhybrid debt or depository instrument issued by the same or similar issuer;
4. not have a commodity component that is separable from the debt or depository instrument;
5. not settle by means of a delivery instrument that is specified in the rules of a commodities exchange; and
6. not be marketed as being or having the attributes of a futures contract or commodity option.

54 Fed. Reg. 1139, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,379 (CFTC Jan. 11, 1989).

165 54 Fed. Reg. 1128, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,378 (CFTC .Jan. 11, 1989).

166 54 Fed. Reg. 30,684, 21 Sec. Reg. & L. Rep. (BNA) 1125 (CFTC July 21, 1989), adopting Regs. §§34.1 - 34.3, 17 C.F.R. §§34.1 - 34.3, CCH Rep. ¶¶ 2761-2763.

167 In adopting the exemption, the Commission made it clear that it "did not intend to address the entire universe of hybrid instruments in the proposed rules, but rather to establish an exemptive framework applicable to categories of instruments in which issuers have expressed an interest." 54 Fed. Reg. 30,684, 21 Sec. Reg. & L. Rep. (BNA) 1125 (CFTC July 21, 1989).

168 The Commission's exemptions have been attacked as an abdication of the CFTC's statutory jurisdiction. *See* CBT Says Hybrid Releases Contradict Congressional Intent, 21 Sec. Reg. & L. Rep. (BNA) 359 (Mar. 3, 1989). *See also, e.g.*, CME Says Flybrid Exemption Based on Regulatory Deference "Misguided," 21 See. Reg. & L. Rep. (BNA) 607 (Apr. 21, 1989) (the Chicago Mercantile Exchange suggested that the deference to other regulatory agencies should not be based solely on the existence of other regulatory schemes, but rather should be based on a finding that either the instruments do not raise issues implicating CFTC regulation or that the other agencies regulating the instruments to be exempted carry on their regulation in a manner truly comparable to that of the Commission). In responding to these criticisms, the Commission explained that the exemption for hybrid commodity-indexed debt and preferred equity interests does not represent a transfer of regulatory responsibility for option instruments subject to another regulatory scheme. Instead the rule identifies certain debt, preferred equity, or depository instruments in which the commodity option component is not predominant and which meet performance criteria intended to assure that Commission regulation in addition to that of another regulator would be unnecessary.

54 Fed. Reg. 30,684, 21 Sec. Reg. & L. Rep. (BNA) 1125 (CFTC July 21, 1989).

169 Reg. §34.1(6), 17 C.F.R. §34.1(6), CCH Rep. ¶ 2761. *See* 54 Fed. Reg. 30,684, 21 Sec. Reg. & L. Rep. (BNA) 1125 (CFTC July 21, 1989). The Commission anticipated that in the future there may be further exemptive action taken with regard to other equity-based instruments:

> Although the Commission is currently expanding the definition of hybrid instruments in the final rule only to the extent of including those preferred equity interests for which an implied option premium can be calculated, this action does not foreclose further consideration of other forms of equity interests when the Commission has gained further experience relevant to measurement of the commodity-dependent payment.

Indeed, following the Futures Trading Practices Act of 1992, the CFTC issued new and more liberal exemptive rules for hybrid instruments. Reg. §§34.1 - 34.3, 17 C.F.R. §§34.1 *et seq.*

See also, e.g., CFTC Interpretative Ltr. No. 94-93, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,249 (CFTC Off-Exchange Task Force July 27, 1994) (financial instruments based on the pricing of a single company's stock were designed to be economically equivalent to options on individual stocks and thus were neither futures contracts nor subject to the CFTC's jurisdiction); CFTC Interpretative Ltr. No. 94-32, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,042 (CFTC Off-Exchange Task Force Feb. 4, 1994) (same). *See generally* Karol & Lehman, Equity Derivatives, 27 Rev. Sec. & Commod. Reg. 121 (1994). *See also, e.g.*, D.M. Lynn, Enforceability of Over-the-Counter Financial Derivatives, 50 Bus. Law. 291 (1994); Roberta Romano, A Thumbnail Sketch of Derivative Securities and Their Regulation, 55 Md. L. Rev. I (1996).

170 *See* 54 Fed. Reg. 1128, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,378 (CFTC Jan. 11, 1989).

171 The option hybrid exemption was available for a variety of commodity-based instruments. The exemption was available for a security that is registered under the Securities Act of 1933 or one that is exempt under §3 as a bank guaranteed security, a short-term commercial paper, an annuity contract, or an insurance contract. Reg. §§34.2(a)(1)(i) (v), 17 C.F.R. §§34.2(a)(1)(i) (v), CCH Rep. ¶ 2761. *See* 15 U.S.C. §§77c(a)(2), (3), (5), (8). Also exempt from CFTC regulation were qualifying securities issued in a transaction that is exempt from registration under the Securities Act as not involving a public offering. Reg. §34.2(x)(I)(vi), 17 C.F.R. §34.2(x)(I)(vi), CCH Rep. ¶ 2761. *See* 15 U.S.C. §77d(2). Finally, qualifying bank depository instruments also qualified for the option hybrid exemption. Reg. §34.2(a)(1)(vii), 17 C.F.R. §34.2(a)(I)(vii), CCH Rep. ¶ 2762. *See* 12 C.F.R. §§204.2(b)(1), (c)(1), (e). These features have been carried forward to the CFTC's present Part 34 Regulations.

172 This is defined to mean a yield that results from "indexing to, or calculation by reference to, the price of a commodity." Reg. §34.1(d), 17 C.F.R. §34.1(d), CCH Rep. ¶ 2761. *See also* the definition of commodity-based option payment in Reg. §34.1(e), 17 C.F.R. §34.1(e), CCH Rep. ¶ 2761.

173 The implied option premium is the issue price of the instrument less the present or discounted value of the commodity independent payments. Reg. §34.1(t), 17 C.F.R. §34.1(1), CCH Rep. ¶ 2762.

174 Reg. §34.2(a)(2), 17 C.F.R. §34.2(a)(2), CCH Rep. ¶ 2762. This standard has not been revised to allow commodity indexation of less than 50 percent of the instrument's value.

175 The solvency criteria were met if one of several conditions exist. The exemption was available if

1. The instrument was rated in one of the top four categories by a nationally recognized investment or financial rating organization. (If the instrument was not rated this requirement can be satisfied if a comparable instrument of the issuer had been so rated);
2. The issuer had at least $100 million in net worth;
3. The instrument was eligible for insurance by a United States government agency or United States chartered corporation; or
4. The issuer maintained certain letters of credit covering the commodity to which the instrument is indexed.

Reg. §34.2(a)(3), 17 C.F.R. §34.2(a)(3), CC11 Rep. ¶ 2762.

176 Reg. §34.2(a)(4), 17 C.F.R. §34.2(a)(4), CCH Rep. ¶ 2762.

177 Reg. §34.2(a)(5), 17 C.F.R. §34.2(a)(5), CCH Rep. ¶ 2762.

178 Reg. §34.3, 17 C.F.R. §34.3, CCH Rep. ¶ 2763.

179 Reg. §34.2(b), 17 C.F.R. §34.2(b), CCH Rep. ¶ 2762.

180 Statutory Interpretation Concerning Certain Hybrid Instruments, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,805 (CFTC Apr. 11, 1990).

181 *See also, e.g.*, CFTC-OETF Interpretative Ltr. No. 90-2, [1987-1990 Transfer Binder] Comm. Fut. 1. Rep. (CCH) ¶ 24,625 (Mar. 2, 1990) (exempting hybrid instruments of foreign banks subject to regulatory supervision by the New York Banking Department).

182 7 U.S.C. §§6. *See infra* §1.02[6] for a discussion of this exemptive authority.

183 Reg. §34.3(a)(1), 17 C.F.R. §34.3(a)(1), CCH Rep. ¶ 2763. "A demand deposit, time deposit or transaction account within the meaning of 2 C.F.R. §204.2(b)(1), (c)(I) and (e), respectively, offered by an insured depository institution as defined in Section 3 of the Federal Deposit Insurance Act; an insured credit union as

defined in Section 101 of the Federal Credit Union Act; or a Federal or State branch or agency of a foreign bank as defined in Section 1 of the International Banking Act." Reg. §34.3(a)(1)(ii), 17 C.F.R. §34.3(a)(1)(ii), CCH Rep. TI 2763. *See* Regulation of Hybrid Instruments, 58 Fed. Reg. 5580, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,538 (CFTC Jan. 22, 1993).

184 Reg. §34.3(a)(2), 17 C.F.R. §34.3(a)(2), CCH Rep. ¶ 2763. Commodity dependent value is defined in terms of that portion of the value that results from indexing to, or calculation by reference to, the price of a commodity. Reg. §§34.2(d), (e), 17 C.F.R. §§34.2(d), (e), CCH Rep. ¶ 2762.

185 Reg. §34.3(a)(4), 17 C.F.R. §34.3(a)(4), CCH Rep. ¶ 2763. The Regulation speaks in terms of an exemption for hybrids that have been issued "subject to applicable federal and state banking laws." The General Counsel has since clarified that this language was not designed to exclude hybrids originally issued outside the United States but eventually transferred here. Accordingly, the exemption may be available for qualified hybrid securities originally issued in an extraterritorial transaction to a foreign person if, in a secondary transaction, the instrument is transferred to a United States person or foreign person in the United States. *See* CFTC Staff Issues Interpretation on Hybrids Transferred to the U.S., 25 Sec. Reg. & L. Rep. (BNA) 922 (July 2, 1993).

186 Reg. §34.3(a)(3), 17 C.F.R. §34.3(a)(3), CCH Rep. ¶ 2763. The regulation makes clear that the full payment requirement precludes provisions for additional out-of-pocket payments to the issuer during the life of the instrument.

187 The exemption for hybrids does not extend, however, to former section 2(a)(1)(B) 's provisions relating to the Commission's jurisdiction, although the CFTC's antifraud and manipulation prohibitions no longer applied to those transactions. In contrast, the exemption for swap transactions did not include an exemption from the antifraud and antimanipulation provisions. *See supra* §1.02[2] and discussion *infra.*

188 Section 2(f), 17 U.S.C. §2(f), CCH Rep. ¶ 1026.

189 *See generally* Hiden, Crawshaw & Willman, Certain Regulatory Considerations Regarding Equity Swaps, 1 I Commod. L. Ltr. 1 (Nov. 1991); Note, Financial Innovation and Derivatives Regulation: Minimizing Swap Credit Risk Under Title V of the Futures Practices Act of 1992, 1994 Colum. Bus. L. Rev. 73 (1994); Note, Oil Price Swaps: Should These Innovative Financial Instruments Be Subject to Regulation by the Commodity Futures Trading Commission or the Securities and Exchange Commission, 93 Dick. L. Rev. 367 (1989).

190 CFTC Policy Statement on Certain Swap Transactions, 21 Sec. Reg. & L. Rep. (BNA) 1136 (July 21, 1989).

In most cases, swap transactions will not be subject to the federal securities laws either. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996) (interest rate swaps lacked commonality and thus were not investment contracts).

191 CFTC Policy Statement on Certain Swap Transactions, 21 Sec. Reg. & L. Rep. (BNA) 1136 (July 21, 1989). The Commission has indicated that the exemption is further conditioned on the swap agreements not being part of a fungible class of agreements that are standardized as to their material economic terms. CFTC Interpretative Ltr. No. 98-01, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,226 (CFTC Div. of Trading & Markets Jan. 7, 1998).

192 *See supra* §1.02[2][C] and *infra* §1.02[6].

193 Reg. §§35.1(b)(2)(i) - (xi) 17 C.F.R. §§35.1(b)(2)(1) - (xi), CCH Rep. ¶ 2771. *See, e.g.*, CFTC Interpretative Ltr. No. 95-61, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,463 (CFTC Div. of Trading & Markets June 20, 1995) (natural persons with a net worth of $1 million or more are not eligible to participate in exempt swap transactions).

194 *See supra* §1.02[2].

195 Section 2(g), 7 U.S.C. §2(g), CCH Rep. ¶ 1027. *But cf.* CFTC v. Calvary Currencies, LLC, 437 F. Supp. 2d 453 (D. Md. 2006) (foreign currency transactions were futures transactions rather than spot transactions; defendant was a counterparty to a futures transaction and thus subject to CFTC jurisdiction in an action claiming defendant engaged in illegal off-exchange futures transactions).

196 *See, e.g.*, A.R. Waldman (Note), OTC Derivatives and Systematic Risk: Innovative Finance or the Dance into the Abyss?, 43 Am. U. L. Rev. 1023 (1994). The Ninth Circuit has described a swap transaction as:

> A "swap" is a contract between two parties ("counterparties") to exchange ("swap") cash flows at specified intervals, calculated by reference to an index. Parties can swap payments based on a number of indices including interest rates, currency rates and security or commodity prices.
>
> The "plain-vanilla" interest rate swap, the simplest and most common type of swap contract, obligates one counter-party to make payments equal to the interest which would accrue on an agreed hypothetical principal amount ("notional amount"), during a given period, at a specified fixed interest rate. The other counterparty must pay an amount equal to the interest which would accrue on the same notional amount, during the same period, but at a floating interest rate. If the fixed rate paid by the first counterparty exceeds the floating rate paid by the second counterparty, then the first counter-party must pay an amount equal to the difference between the two rates multiplied by the notional amount, for the specified interval. Conversely, if the floating rate paid by the second counterparty exceeds the fixed rate paid by the first counter-party, the fixed-rate payor receives payment. The agreed hypothetical or "notional" amount provides the basis for calculating payment obligations, but does not change hands.

Thrifty Oil Co. v. Bank of America Nat'l Trust and Savings Ass'n, 310 F.3d 1188, 1191 (9th Cir. 2002), *as amended*, 322 F.3d 1039 (9th Cir. 2002).

197 *See* Report on S. 207 of the Senate Committee on Agriculture, Nutrition, and Forestry, Sen. Rep. No. 102-22, 102d Cong., 1st Sess. (Mar. 12, 1991).

198 Under the legislation as proposed, the Act would not apply to a commodity option if less than 50 percent of the option's value is derived from the commodity option, nor would it apply to a futures contract if it is expected that less than 50 percent of its price movement would be attributable to the underlying commodity.

199 *See infra* §4.05[8].

200 For a critique of the proposal *see* Nathan, The Statutory Definition of a "Future," 12 Futures Int'l. Ltr. I (Apr. 1992). *See also* Definition of Futures Contract Would Create Problems, CFTC Warns, 24 Sec. Reg. & L. Rep. (BNA) 704 (May 8, 1992) (letter from Chairman Graham to House Agriculture Conservation, Credit, and Rural Development Subcommittee).

201 17 C.F.R. §§36.1 *et seq*. (rescinded). Exchange products, other than certain listed agricultural products and products based on a stock index, were eligible for the exemption so long as they were not traded on an exchange. The exemption did not affect the coverage of the antifraud and antimanipulation rules; nor did it exclude these products from the application of the segregation and net capital requirements. Additionally, both the express private rights of action and the Commission's reparations proceedings were preserved for those professional and institutional investors trading in these qualifiedly exempt off-exchange products.

202 [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,282 (CFTC 1998). Previously, in 1997, the Commission discontinued its Off Exchange Taskforce and determined that all related matters should henceforth be directed to the Office of General Counsel. *See* Comm. Fut. L. Rep. (CCH), Report Bull. No. 556 (1997). *See also, e.g.*, Kimberly D. Krawiec, More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives, 23 J. Corp. L. 1 (1997). *Cf.* Willa E. Gibson, Investors, Look Before You Leap: The Suitability Doctrine Is Not Suitable for OTC Derivatives, 29 Loy. U. Chi. L.J. 527 (1998).

203 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

204 Section 5d, 7 U.S.C. §7a-3-, CCH Rep. ¶¶ 1230-1236 (exempt boards of trade).

205 17 C.F.R. §§36.1 *et seq.*

206 *See infra* §1.18[6].

207 Section 2(d), 7 U.S.C. §2(d), CCH Rep. ¶ 1024, CFMA §103.

208 Section 1a(13), 7 U.S.C. §1a(13), CCH Rep. ¶ 1002, CFMA §101.

209 Joint Statement of the CFTC, SEC, and U.K. Securities & Investment Board, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,003 (March 15, 1994). *See also* the 1993 CFTC study of the over-the-counter derivatives markets. [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,877 (CFTC 1993); Finkle, The CFTC's Study of Swaps and Off-Exchange Derivatives Trading: A Review, 13 Fut. Int'l L. Letter 1 (nos. 9-10 November/December 1993).

210 7 U.S.C. §6(c), CCH Rep. ¶ 1035.

211 Special Report, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 79 (Oct. 23, 1992).

212 57 Fed. Reg. 53,627 (Nov. 12, 1992), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,511.

213 57 Fed. Reg. 53,618 (Nov. 12, 1992), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,510.

214 Special Report, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 83-84 (Oct. 23, 1992).

215 *Id.* at 81.

216 Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694 (July 21, 1989), reprinted at [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,494.

217 57 Fed. Reg. 53,627 (Nov. 12, 1992), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,511.

218 Over-the-Counter Derivatives Markets and the Commodity Exchange Act: Report of the President's Working Group on Financial Markets, at 19-21 (November 1999). The other members of the working group were the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission.

219 Section 5b, 7 U.S.C. §7b, CCH Rep. ¶¶ 1213-1220.

220 The Regulation denies an exemption if otherwise qualifying swap transactions are executed through "multilateral transaction facilities," which are physical or electronic facilities that link market participants simultaneously with the capability of entering into binding contracts among themselves. Reg. §35.2(d), 17 C.F.R. §35.2(d), CCH Rep. ¶ 2772. The limitation is designed to preclude centralized trading (including screen-based trading) but is not meant to preclude access to computerized information so long as the swap participants do not use the systems like a central market to enter orders or execute transactions among themselves. *See* Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,539 (CFTC Jan. 22, 1993).

221 Exemption for Certain Swap Agreements, 58 Fed. Reg. 5587, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,539 (CFTC Jan. 22, 1993).

222 Reg. §§35.1(2)(i) - (xi) 17 C.F.R. §§35.1(2)(i) - (xi), CCH Rep. ¶ 2771. *See, e.g.*, CFTC Interpretative Ltr. No. 95-61, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,463 (CFTC Div. of Trading & Markets June 20, 1995) (natural persons with a net worth of $1 million or more are not eligible to participate in exempt swap transactions). *See also, e.g.*, CFTC Interpretative Ltr. No. 98-01, [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,226 (CFTC Div. of Trading & Markets Jan. 7, 1998) (exemption is conditioned on the swap agreements not being part of a fungible class of agreements that are standardized as to their material economic terms).

223 *See supra* §1.02[2].

224 17 C.F.R. §§36.1 *et seq.*, CCH Rep. ¶¶ 2781 *et seq. See supra* §§1.02[2], 1.02[5].

225 Section 5d, 7 U.S.C. §7a-3, CCH Rep. ¶¶ 1230-1236.

225.1 Section 4(c)(1); 7 U.S.C. § 6(c)(1). The CFTC is not permitted to grant exemptions, unless expressly authorized in subparagraph (c)(1) of Section 4 of the Commodity Exchange Act, with respect to amendments made by Subtitle A of the Dodd-Frank Act with respect to (i) paragraphs (2), (3), (4), (5); and (7), paragraph

(18)(A)(vii)(III), paragraphs (23), (24), (31), (32), (38), (39), (41), (42), (46), (47), (48); and (49) of Section 1a, and Sections 2(a)(13), 2(c)(1)(D), 4a(a), 4a(b), 4d(c), 4d(d), 4r, 4s, 5b(a), 5b(b), 5(d), 5(g), 5(h), 5b(c), 5b(i), 8e, and 21 (which include the definitions of "cleared swap," "major security-based swap participant," "security," "security-based swap," "swap" and "swap dealer," and certain requirements of the Act such as position limits and registration requirements) and (ii) section 206(e) of the Gramm-Leach-Bliley Act. The CFTC is not permitted to grant exemptions, unless expressly authorized in subparagraph (c)(1) of section 4 of the Commodity Exchange Act, with respect to amendments made by Subtitle A of the Act in sections 721(c) and 742 of the Act. The CFTC and SEC may by rule, regulation or order jointly exclude any agreement, contract or transaction from section 2(a)(1)(D) of the Commodity Exchange Act, which provides the SEC with jurisdiction over security futures, options on security futures and persons affecting transactions on security futures and options on security futures.

226 *See also* the discussion *supra* §1.02[2] (commodities and jurisdiction) and *infra* §1.02[8] (the deterioration of the contract market monopoly), §4.05[8] (challenges to the Commission's jurisdiction), §4.05[9] (ongoing jurisdictional assaults), and §4.05[10] (reflections on CFTC/SEC jurisdiction).

227 42 Stat. 187, enacted Aug. 24, 1921. *See also* the discussion of the legislative history of this Act in In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941, at pp. 23,779-23,781 (CFTC 1979).

Stein, The Exchange-Trading Requirement of the Commodity Exchange Act, 41 Vand. L. Rev. 473 (1988).

228 Hill v. Wallace, 259 U.S. 44 (1922). *See also* Trusler v. Crooks, 269 U.S. 475 (1926).

229 42 Stat. 998, enacted Sept. 21, 1922.

230 Board of Trade of the City of Chicago v. Olsen, 262 U.S. I (1923).

231 7 U.S.C. §6 (prior to its amendment).

232 A bucket shop allows customers to speculate on movements in commodity prices by entering into contracts with the shop rather than by finding a trading partner on the floor of an exchange. These shops are viable only as long as they maintain a rough balance between the value of their buy and sell contracts, and their customers pay any debts they owe. When a shop miscalculates, as inevitably occurs, its owners are likely to close shop without settling accounts. *See* CFTC v. Baragosh, 278 F.3d 319, 323-324 (4th Cir. 2002).

The "bucket shops" that operated long ago were based on a failure to enter customer orders and thus turning the apparent transactions into illegal difference contracts. *See, e.g.*, Board of Trade of City of Chicago v. Christie Grain & Stock Co., 198 U.S. 236, 246, 25 S.Ct. 637, 638, 49 L.Ed. 1031 (1905) (describing bucket shops as "places wherein is permitted the pretended buying and selling of grain, etc., without any intention of receiving and paying for the property so bought, or of delivering the property so sold."); Bergstrom v. Ridgway Co., 138 A.D. 178, 181, 123 N.Y.S. 29, 32 (1st Dep't. 1910) ("A ‘bucket shop’ is a place where wagers are made on the fluctuations of the market price of securities or commodities."); Louis Loss & Joel Seligman, Securities Regulation §1-B-4 n.130 (3d ed. 1989) ("The customer may think that he is effecting a legitimate purchase, but the broker ‘buckets’ the order instead of executing it. If the market goes down, as the broker hopes, he purports to sell the customer out and pockets the difference; if it goes up and the broker is not able or willing to cover from profits on other transactions, he either defaults or decamps."). The current version of bucket shop tactics is to take "the opposite side of a customer's order rather than openly and competitively executing the order on an exchange." Commodity Futures Trading Commission v. Baragosh, 278 F.3d 319, 322 (4th Cir. 2002).

> "A bucket shop is defined to be an office, store, board of trade room, or other place wherein the proprietor or keeper thereof or other person or agent, either in his or its own behalf or as an agent or correspondent of any other person, corporation, association or copartnership within or without the state, conducts the business of making or offering to make contracts, agreements, trades or transactions respecting the purchase, or purchase and sale, of any stocks, grains, provisions, cotton or other commodity or personal property, wherein such proprietor or keeper or patron

> contemplates or intends that the contracts, agreements, trades or transactions shall be, or may be, closed, adjusted or settled according to or upon the basis of the market quotations or prices made on any board of trade or exchange where there is competitive buying and selling, and upon which the commodities or securities referred to in such contracts, agreements, trades or transactions are dealt in, and without a bona fide transaction on such board of trade….."

Commodity Traders, Inc. v. Palmer, 203 Neb. 667, 670, 280 N.W.2d 49, 52 (Neb. 1979), *quoting* Neb. Rev. Stat. §28-945. *See also* Commodity Futures Trading Commission v. Baragosh, 278 F.3d 319, 322 4th Cir. 2002):

> In effect, a bucket shop "assumes the risk of the transaction that would be assumed by the market in an exchange transaction." Such shops are viable only so long as they maintain a rough balance between the value of their buy and sell contracts and customers pay any debts they owe. When a shop miscalculates, as inevitably occurs, its owners are likely to close shop without settling accounts. In the first decades of the twentieth century, the common law disfavored bucket shops by refusing to enforce their contracts with speculators, and many state legislatures imposed civil or criminal penalties on bucket shop operators.

Id. at 323 (citation omitted).

For a discussion of the history of difference contracts and bucket shops, *see* Thomas Lee Hazen, Rational Investment, Speculation, or Gambling?—Derivative Securities and Financial Futures and Their Effects on the Underlying Capital Markets, 86 Nw U. L. Rev. 987 (1992). *See also, e.g.,* Christopher T. Pickens, Comment, Of Bookies and Brokers: Are Sports Futures Gambling or Investing, and does it Even Matter?, 14 Geo. Mason L. Rev. 227 (2006).

233 *See infra* §5.07[2].

234 7 U.S.C. §6 (prior to its amendment).

235 *Id. See, e.g.*, Architzel & Tosini, A Framework for Current Issues Regarding Off-Exchange Instruments, 7 Comm. L. Ltr. 3 (April 1987). *See also, e.g.*, Hiden & Crawshaw, New Wave Instruments: Indexed Off-Exchange Obligations, 7 Comm. L. Ltr. 1 (March 1987).

236 *See* H. R. Rep. No. 421, 74th Cong., 1st Sess. 5 (1935), and the discussion of original §4b (7 U.S.C. §6b, with subsequent changes).

237 *See* 80 Cong. Rec. 8088 (1936). *See also* Report on H.R. 13,113 of the House Agriculture Committee, H.R. Rep. No. 975, 93d Cong. 2d Sess. 161 (April 4, 1974).

238 7 U.S.C. §6b, CCH Rep ¶ 1051.

239 Effective federal enforcement against bucket shop operators frequently was thus problematic because of the Act's ambiguity. *See* Smith, The Commodity Futures Trading Commission and the Return of Bucketeering: A Lesson in Regulatory Failure, 57 N.D. L. Rev. 7 (1981).

240 *E.g.*, N.Y. Gen. Bus. L. §359-e(14) (McKinney Supp. 1987); Wash. Rev. Code Ann. §§21.25.010-21.25.900 (Supp. 1987). *See* Allen, Kicking the Bucket Shop: The Model State Commodity Code as the Latest Weapon in the State Administrator's Anti-Fraud Arsenal, 42 Wash. & Lee L. Rev. 889 (1985).

241 Section 12(e), 7 U.S.C. §16(e), CCH Rep. ¶ 1371.

242 Salomon Forex, Inc. v. Tauber, 8 F.3d 966 (4th Cir. 1993), *cert. denied*, 511 U.S. 1031, *aff'g* 795 F. Supp. 768 (E.D. Va. 1992). *See* C.R. Webb (Note), Salomon Forex, Inc. v. Tauber [8 F.3d 966 (1993)] —The "Sophisticated Trader" and Foreign Currency Derivatives Under the Commodity Exchange Act, 19 N.C. J. Int'l & Com. Reg. 597 (1994).

243 CFTC v. Dunn, 58 F.3d 50 (2d Cir. 1995), *rev'd*, 519 U.S. 465 (1997). *See also* Lehman Brothers Commercial Corp. v. Minmetals International Non-Ferrous Metals Trading Co., 27 Sec. Reg. & L. Rep. (BNA) 1719 (S.D.N.Y. 1995) (upholding jurisdiction with respect to certain foreign exchange and swap transactions).

244 The court decided to follow the interpretation from its earlier decision in CFTC v. American Board of Trade, 803 F.2d 1242 (2d Cit. 1986). It further observed that it was for the Supreme Court, not the Second Circuit, to resolve the conflict.

245 Philip M. Johnson & Thomas L. Hazen, Commodities Regulation §2.00 at 251-252 (2d ed. 1989). *See also supra* §1.02[7].

246 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

247 *See infra* §§1.02[9], 1.12[1]. Court decisions, however, have excluded from CFTC jurisdiction options on instruments enumerated in the Treasury Amendment discussed at *infra* §1.02[8][D].

248 These new exotics are not subject to the securities laws. *See* Procter & Gamble Co. v. Bankers Trust Co., [1994-1996 Transfer Binder] Fed. Sec. L. Rep. (CCH)11 99,229 (S.D. Ohio 1996) (interest rate swaps lacked a common enterprise commonality and thus were not "investment contracts"). In order to be a security, an investment contract must involve a pooling of interest among investors or between the investor and the promoter. *See* 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §1.6 (Practitioner's Ed. 4th ed. 2002).

249 52 Fed. Reg. 47,002 (December 11, 1987), reprinted at [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,995.

250 54 Fed. Reg. 30,694 (July 21, 1989), reprinted at [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,494. *See also, e.g.*, A.R. Waldman (Note), OTC Derivatives and Systematic Risk: Innovative Finance or the Dance into the Abyss?, 43 Am. U. L. Rev. 1023 (1994).

251 *Cf.* Dunn v. CFTC, 519 U.S. 465 (1997) (off-exchange foreign currency transactions are not subject to CFTC jurisdiction); In the Matter of Global Link Miami Corp., [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,669 (CFTC 1999), reversing [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,391 (CFTC Initial Dec. 1997) (foreign currency futures transactions—i.e. currency swaps—were found to be traded on a board of trade and thus subject to CFTC jurisdiction even though not traded on an organized exchange).

252 [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,494, p.36,143.

253 Commodity Exchange Act §§4(a), 7 U.S.C. §6(a).

254 7 U.S.C. §2(a)(1)(B)(v) (1999) (repealed 2000).

255 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

256 *See infra* §1.18[8].

257 *See* CFTC Policy Statement on Certain Swap Transactions, 21 Sec. Reg. & L. Rep. (BNA) 1136 (July 21, 1989).

[258] [Reserved.]

259 For a discussion of these earlier rules, *see* 54 Fed. Reg. 30,684 (July 21, 1989), reprinted at [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,493.

260 7 U.S.C. §6c(b), CCH Rep. ¶1062.

261 54 Fed. Reg. 1139 (January 11, 1989), reprinted at [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,379. This interpretation was subsequently revised to conform with certain aspects of the hybrid rules adopted later in that year. 55 Fed. Reg. 135,582 (April 11, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,805.

262 *See* CCH Rep. ¶ 24,379, at p.35,646.

263 7 U.S.C. §6(c)(5)(B).

264 H.R. Conf. Rep. No-102-978 at 81 (Oct 2, 1992), reprinted in 1992 U.S.C.C.A.N. 3179, (as quoted in In re Thrifty Oil Co., 310 F.3d 1188, 1205 (9th Cir. 2002), *as amended*, 322 F.3d 1039 (9th Cir. 2002), *aff'g* Thrifty Oil Co., 249 B.R. 537, 2000 WL 776871 (S.D. Cal 2000):

> The goal of providing the Commission with broad exemptive powers is not to provide a wide-scale deregulation of markets falling within the ambit of the [CEA]. Rather, it is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner.…
>
> The conferees expect and strongly encourage the Commission to use its exemptive powers promptly upon enactment of this legislation in four areas where significant concerns of legal uncertainty have arisen: (1) hybrids, (2) swaps, (3) forwards, and (4) bank deposits and accounts.

265 In addition to other types of swap and hybrid transactions, the new exemptions were able to give certainty to the non-debtor swap counterparties in bankruptcy. *See* In re Thrifty Oil Co., 310 F.3d 1188, 1191 (9th Cir. 2002), *as amended*, 322 F.3d 1039 (9th Cir. 2002), *aff'g* 249 B.R. 537, 2000 WL 776871 (S.D. Cal 2000), holding that the termination damages under an interest rate swap agreement, entered into between a lender and a borrower as part of a larger financing arrangement, do not constitute unmatured debt interest disallowed under 11 U.S.C. §502(b)(2). As the court pointed out, "[s]everal provisions in the Bankruptcy Code reflect a strong Congressional policy of protecting interest rate swaps, termination damages and the swap markets from the effects of bankruptcy." *Id.* at 1199.

266 A New Regulatory Framework for Multilateral Transaction Execution Facilities, Intermediaries and Clearing Organizations, 65 FR 39039-01, 2000 WL 795027 (CFTC June 22, 2000); Exemption for Bilateral Transactions, 65 FR 39033, 2000 WL 795026 (CFTC June 22, 2000). *See infra* §2.02[7].

A true over-the-counter market was created with the enactment of the Commodity Futures Modernization Act of 2000. Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

267 *See* 32 Fed. Sec. & L. Rep. (BNA) 647 (May 15, 2000).

268 *See* 32 Fed. Sec. & L. Rep. (BNA) 828, 861 (June 26, 2000).

269 32 Sec. Reg. L. Rep. (BNA) 1256 (Sept. 18, 2000).

270 58 Fed. Reg. 5587 (January 22, 1993), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,539 at p.39,589 n.11 (swaps); and 57 Fed. Reg. 53,618 (November 12, 1992), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,510 at p.39,455 (hybrids).

271 7 U.S.C. §16(e)(2)(a) (prior to its amendment in 2000). The current version of that section provides:

> (2) This chapter shall supersede and preempt the application of any State or local law that prohibits or regulates gaming or the operation of bucket shops (other than antifraud provisions of general applicability) in the case of—
>
> (A) an electronic trading facility excluded under section 2(e) of this title; and
>
> (B) an agreement, contract, or transaction that is excluded from this chapter under section 2(c), 2(d), 2(f), or 2(g) of this title or sections 27 to 27f of this title, or exempted under section 2(h) or 6(c) of this title (regardless of whether any such agreement, contract, or transaction is otherwise subject to this chapter).

7 U.S.C. §16(e)(2), CCH Rep. §1371.

272 H.R. Conf. Rep. No-102-978 at 80 (Oct 2, 1992), reprinted in 1992 U.S.C.C.A.N. 3179, 3212 (as quoted in In re Thrifty Oil Co., 249 B.R. 537, 2000 WL 776871 (S.D. Cal 2000) :

> Section 502(c) of the [FPTA] amends section 12(e)(2)(A) of the [CEA] to provide that any State or local law that prohibits or regulates gaming or the operation of "bucket shops" (other than anti-fraud provisions of general applicability) shall not apply with respect to a transaction or class of transactions that has received or is covered by an exemption granted by the Commissions under section 4(c). It thus provides legal certainty under both the [CEA] and state gaming and bucket shop laws for transactions covered by the terms of an exemption.

273 The preemptive effect extends to swap agreements entered into and terminated prior to the adoption of the 1992 amendments to the Act. In re Thrifty Oil Co., 310 F.3d 1188 (9th Cir. 2002), *as amended*, 322 F.3d 1039 (9th Cir. 2002). The court there stated: "Construing the FTPA to permit retroactive exemption from the CEA but only prospective exemption of state bucket laws would create a layer of uncertainty where none existed before.… Congress preempted state bucket shop laws to the full extent the CFTC exempts transactions from coverage under the CEA."

274 In re Thrifty Oil Co., 310 F.3d 1188, 1205 (9th Cir. 2002), *as amended*, 322 F.3d 1039 (9th Cir. 2002), *aff'g* 249 B.R. 537, 2000 WL 776871 (S.D. Cal 2000).

275 CFTC Regulations Part 35, 17 C.F.R. §§35.1 - 35.2.

276 CFTC Regulations Part 34, 17 C.F.R. §§34.1 - 34.2.

277 CFTC Regulations Part 34, 17 C.F.R. §§34.1 - 34.2.

278 76 Fed. Reg. 49291, 49296 (CFTC Aug. 10, 2011).

279-300 [Reserved.]

301 *See, e.g.*, Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985), reprinted at [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,718. *See also, e.g.*, In re Bybee, 945 F.2d 309, 314-315 (9th Cir. 1991) (when delivery is contemplated but the obligation is deferred because of commercial convenience or necessity, the forward contract exclusion applies). *Compare, e.g.*, CFTC v. Noble Metals Int'l, Inc., 67 F.3d. 766 (9th Cir. 1995) (so-called "forward delivery program" involved futures not forward contracts because it was not contemplated that the customers would take delivery).

302 7 U.S.C. §l a(19), CCH Rep. 1 1002. Prior to the CFMA, this definition was in former section 1a(11).

303 Transnor (Bermuda) Limited v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,829.

304 55 Fed. Reg. 39,188 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) $ 24,925.

305 945 F.2d 309 (9th Cir. 1991), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,138.

305.1 *See* In re National Gas Distribs. LLC v. E.I. Du Pont de Nemours & Co., 556 F.3d 247 (4th Cir. 2009) (remanded for determination of whether contracts were forward or swap contracts for purposes of bankruptcy proceeding).

305.2 In re National Gas Distribs. LLC v. E.I. Du Pont de Nemours & Co., 556 F.3d 247 (4th Cir. 2009) (remanded for determination of whether contract was a forward contract).

305.3 *Cf.* 11 U.S.C. § 101(25)(A) (requiring the same of "forward contracts").

305.4 *See, e.g.,* In re Olympic Natural Gas Co., 294 F.3d 737 (5th Cir. 2002) (the forward contract at issue contained "the price, quantity, timing, and delivery point for the natural gas"); In re Borden, 336 B.R. 214 (Bankr. D. Del. 2006) (the forward contracts at issue contemplated "a specified quantity of natural gas…at a fixed price").

305.5 Non-bankruptcy case law also accords the same meaning to "forward agreement." *Donoghue,* 2006 WL 775122, at *1 (involving quantity of 300,000 shares of stock).

305.6 *Merriam-Webster's Dictionary of Law* (contract), *available at* http://dictionary.reference.com/browse/contract (last visited Jan. 16, 2009).

305.7 *CME Glossary of Terms,* available at http://www.cme.com/glossary/F.html (last visited Jan. 16, 2009) (emphasis added).

306 Commodity Exchange Act §4(c), 7 U.S.C. §6(c). *See supra* §1.02[5]. The use of §4(c) 's exemptive power has not been limited to the new varieties of exotic instruments. For example, the Commission now permits off-exchange trading by professional and institutional investors of certain exchange-listed products. Part 36 of the Commission's Regulations. Regs §§36.1 *et seq.* ; 17 C.F.R. §§36.1 *et seq.*, CCH Rep. ¶¶ 2781-2789.

307 58 Fed. Reg. 21,286 (April 20, 1993), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,633.

308 CFTC Docket No. 95-14, Order Instituting Proceedings Pursuant to Sections 6(c) and 8a of the Commodity Exchange Act and Findings and Order Imposing Remedial Sanctions, 1995 CFTC LEXIS 190 (July 27, 1995) ("Findings").

308.1 CFTC v. Reed, 481 F. Supp. 2d 1190 (D. Colo. 2007) (denying motion to dismiss CFTC action for fraudulent reporting of natural gas transactions). *See also, e.g.,* Geoffrey F. Aronow & Anthony M. Mansfield, Where Might CFTC Manipulation Jurisdiction End In OTC Trading?, 27 Futures & Deriv. L. Rep. 1 (No. 6. June 2007).

308.2 For discussion of the CFTC's role as compared to FERC in policing energy product price manipulation, *see* Mark D. Young, Policing Energy Price Manipulation: Whose Beat? What Rules?, 39 Rev. of Sec. & Commod. Reg. 207 (Nov. 1, 2006).

See also, e.g., United States v. Brooks, 681 F.3d 678, 691–692 (5th Cir. 2012) ("report" as used in section 9(a)(2) of the Act is not limited to official reports but rather applies to any reports containing information relating to matters that affect or tend to affect commodity pricing; upholding convictions for false reports relating to natural gas).

309 *Id.* Findings, p.4. Accord, Cary Oil Co. v. MG Refining & Marketing, Inc., 230 F. Supp. 2d 439, 4512 (S.D.N.Y. 2002) (since companies engaged in marketing and distributing petroleum products entered into flexie contracts with seller for purely speculative purposes, contracts were unlawful for off-exchange futures contracts and were unenforceable, not merely voidable).

310 While many of the participants in hedge to arrive transactions would qualify for "eligible contract participant" status under section 1a(12) of the Act and would normally be able to engage in this activity without CFTC regulation if the underlying commodity is either excluded under section 2(d) or exempted under section 2(h) of the Act, agricultural products generally do not qualify for either status and the futures-versus-forwards analysis becomes unavoidable.

311 *E.g.*, Abels v. Farmers Commodities Corp., 259 F.3d 910, 914-915 (8th Cir. 2001) (discussing nature of hedge-to-arrive contracts); Nagel v. ADM Inv. Serv., Inc., 217 F.3d 436, 438-439 (7th Cir. 2000) (same); Sack Bros. v. Great Plains Co-op., Inc., 616 N.W.2d 796 (Neb. 2001) (finding HTA contracts to be forward contracts and enforceable under state law); Jennifer Durham King & James J. Moylan, Hedge-to-Arrive Contracts: Jurisdictional Issues Under the Commodity Exchange Act, 18 N. 111. U. L. Rev. 481 (1998); Glenn L. Norris, George F. Davison & David N. May, Hedge-to-Arrive Contracts and the Commodity Exchange Act: A Textual Alternative, 47 Drake L. Rev. 319 (1999); Note, Hedge-to-Arrive Contracts and the Commodity Exchange Act, 7 Kan. J.L. & Pub. Pol'y 122 (1998).

312 Top of Iowa Cooperative v. Schewe, 324 F.3d 627 (8th Cir. 2003) (hedge-to-arrive contracts were forward contracts); Abels v. Farmers Commodities Corp., 259 F.3d 910, 917 (8th Cir. 2001); In re Robinson, 265 B.R. 722, 730 (Bankr. 6th Cir. 2001); Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308 (6th Cir. 1998) (hedge-to arrive contracts were cash forward contracts and thus not subject to Commodity Exchange Act's arbitration provisions); Johnson v. Land O' Lakes, Inc., 18 F. Supp. 2d 9,85 (N.D. Iowa 1998) (hedge-to-arrive contracts

were cash forward contracts not subject to CFTC regulation); Great Plains Coop. v. Amundson, 30 Sec. Reg. & L. Rep. (BNA) 1413 (D. Neb. 1998) (leaving open the delivery and destination terms did not prevent hedge-to-arrive contracts from qualifying as cash forward contracts because delivery was clearly contemplated); Barz v. Geneva Elevator Co., 12 F. Supp. 2d 943 (N.D. Iowa 1998) (hedge-to-arrive contracts were forward contracts not subject to CFTC jurisdiction); The Andersons, Inc. v. Crotser, 7 F. Supp. 2d 931 (W.D. Mich. 1998) (hedge-to-arrive contracts were forward contracts and thus not subject to Commodity Exchange Act's arbitration provisions); Oeltjenbrun v. CSA Investors, Inc., 3 F. Supp. 2d 1024 (N.D. Iowa 1998) (hedge-to-arrive contracts were cash forward contracts). *See also, e.g.*, Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777 (7th Cir 1999), *aff'g* 26 F. Supp. 2d 1107 (N.D. Ind. 1998) (grain contracts were forward contracts). *E.g.*, In re Grain Land Coop., 30 Sec. Reg. & L. Rep. (BNA) 1714 (CFTC Initial Dec. 1998) ("flexi" hedge-to-arrive contracts were not forward contracts and thus were subject to CFTC jurisdiction where, among other things, there was no "forced burden of delivery"); In re The Anderson's Inc., 30 Sec. Reg. & L. Rep. (BNA) 72 (CFTC 1998) (grain elevator settled charges that it entered into illegal hedge-to-arrive contracts that were futures rather than forward contracts because producers routinely avoided the delivery obligation).

313 *E.g.*, Gunderson v. ADM Investor Servs., Inc., 2001 U.S. Dist. LEXIS 3383, at *38-42 (N.D. Iowa 2001) (whether the HTAs constituted futures or forwards too fact intensive and could not be resolved in a motion to dismiss); Gunderson v. ADM Investor Servs., Inc., 85 F. Supp. 2d 892, 913 (N.D. Iowa 2000) (same).

314 As pointed out in In the Matter of Wright, 2003 CFTC Lexis 24 *46 (CFTC 2003):

> [I]n terms of delivery contemplation, futures are better described as contracts as to which a critical mass of contract parties do not contemplate making or taking delivery. Conversely, forwards can be described as agreements concerning which a critical mass of contract parties contemplate making or taking delivery. Thus, when evaluating contracts as a class and looking to delivery contemplation, a small percentage of contract parties do not define the contract for all.

315 Top of Iowa Cooperative v. Schewe, 324 F.3d 627 (8th Cir. 2003), *aff'g* 6 F. Supp. 2d 843 (N.D. Iowa 1998) (hedge-to-arrive contracts were forward contracts); Abels v. Farmers Commodities, Corp., 259 F.3d 910, 917 (8th Cir. 2001); Nagel v. ADM Investor Servs., Inc., 217 F.3d 436, 438-442 (7th Cir. 2000); Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983, 987, 996 (8th Cir. 1999); Lachmund v. ADM Investor Servs., Inc., 191 F.3d 777, 785-90 (7th Cir. 1999); Haren v. Conrad Coop., 198 F.3d 683, 683 (8th Cir. 1999); Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 317-22 (6th Cir. 1998); Asa-Brandt, Inc. v. ADM Investor Servs., Inc., 138 F. Supp. 2d 1144, 1165 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003); Patten Farms, 2000 U.S. Dist. LEXIS 21650, at *6-11(S.D. Iowa 2000); CoBank, ACB Corp. v. Alexander, Case No. 3:96CV7687, 1999 U.S. Dist. LEXIS 17288, at *30-31 (N.D. Ohio July 27, 1999) ; In re Gray, 252 B.R. 689, 698-700 (Bankr. S.D. Ohio 2000) (most, but not all, of the HTAs before it were forward contracts); Sack Bros. v. Great Plains Coop., Inc., 616 N.W.2d 796, 800-09 (Neb. 2000); Maynard Coop. Co. v. Recker, 2001 Iowa App. LEXIS 705, at *3-5 (Iowa Ct. App. 2001); Blanchard Valley Farmers Coop., Inc. v. Rossman, 761 N.E.2d 1156, 1161-62 (Ohio Ct. App. 2001); Blanchard Valley Farmers Coop., Inc. v. Carl Niese & Sons Farms, Inc., 758 N.E.2d 1238, 1242 (Ohio Ct. App. 2001); In the Matter of Wright, 2003 CFTC Lexis 24 (CFTC 2003).

316 *E.g.*, Oelijenbrun v. CSA Investors, Inc., 3 F. Supp. 2d 1024 (N.D. Iowa 1998) (hedge-to-arrive contracts were cash forward contracts even though they had been rolled over several times).

CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) (foreign currency rollover contracts sales were forward contracts and thus not subject to the Act); Nagel v. ADM Investor Servs, Inc. 217 F.3d 436 (7th Cir. 2000) (hedge to arrive contracts were forward contracts).

317 Division of Economic Analysis Statement of Policy in Connection with the Unwinding of Certain Existing Contracts for the Delivery of Grain and Statement of Guidance Regarding Certain Contracting Practices, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,691 (CFTC Div. Of Econ. Analysis May 15, 1996).

318 *See* CFTC's Division of Economic Analysis Issues Statements of Policy and Guidance Relating Hedge-to-Arrive Contracts, 1998 WL 253833 (May 15, 1996); Comm. Fut. L. Rep. (CCH), Report Bull. No. 528 (June 7, 1996).

319 *See,* e.g., Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1163-1165 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003) (hedge-to-arrive contracts were forward contracts where: they were all on identical form contracts; parties were in business of obtaining or producing subject commodity; contracts limited amount of grain that could be contracted to no more than could be produced or would be delivered in normal crop year by producer; contracts contained definite dates of delivery; contracts were individualized with respect to such terms as quantity, grade, and point of delivery; and delivery could not be deferred forever, since contracts required farmers to pay additional charges every time they rolled the hedge); Gunderson v. ADM Investor Services, Inc., 85 F. Supp. 2d 892 (N.D. Iowa), *reversed on other grounds*, 2000 WL 1154423 (8th Cir. 2000) (fact findings were required to determine whether hedge-to-arrive contract was a futures or a forward contract).

Where an HTA contract contains an arbitration clause, the clause will be enforced notwithstanding the claim that the contract is an illegal off-exchange futures contract. Harter v. Iowa Grain Co., 211 F.3d 338 (7th Cir. 2000).

In L & R Farm P'ship v. Cargill Inc., 963 F. Supp. 2d 798, 804 (W.D. Tenn. 2013), the district court considered the enforceability of a pre-dispute arbitration clause, which plaintiffs contended to be invalid because they were not provided the pre-dispute arbitration disclosures required under CFTC rules for futures contracts. The court held that plaintiffs had failed to establish that there was a genuine dispute of material fact about whether the grain contracts in question were futures contracts within the meaning of the Commodity Exchange Act. *Id*. at 805. The court focused on the unambiguous language of the contracts, which reflected that physical delivery was anticipated and the absence of evidence that physical delivery was not actually anticipated. The court applied the forward contract analysis set out in Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 318 (6th Cir. 1998) (when "determining whether a particular commodities contract falls within the cash forward exemption [to the Commodity Exchange Act], courts must focus on whether there is a legitimate expectation that physical delivery of the actual commodity by the seller to the original contracting buyer will occur in the future") as the controlling precedent. *L&R Farm*, 963 F. Supp. 2d at 806. The plaintiffs having failed to meet their burden of adducing specific evidence that would allow the court to conclude that, contrary to the terms of the contracts, physical delivery was not actually anticipated and that the contracts were therefore futures contracts subject to the Commodity Exchange Act, the district court granted Cargill's motion to compel arbitration. *Id.* at 808–809.

320 In re Robinson, 265 B.R. 722, 730 (Bankr. 6th Cir. 2001); Nagel v. ADM Inv. Serv., Inc., 217 F.3d 436, 441 (7th Cir. 2000); Haren v. Conrad Cooperative, 198 F.3d 683 (8th Cir. 1999) ; Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983 (8th Cir. 1999) ; Lachmund v. ADM Investor Services, Inc., 191 F.3d 777 (7th Cir. 1999) ; Asa-Brandt, Inc. v. ADM Inv. Serv., Inc., 138 F. Supp. 2d 1144, 1163-1165 (N.D. Iowa 2001), *aff'd in part and rev'd in part on other grounds*, 344 F.3d 738 (8th Cir. 2003); Top of Iowa Cooperative v. Sime Farms, Inc., 608 N.W.2d 454 (Iowa 2000) (HTA was exempt forward contract rather than an illegal off-exchange futures contract; enforcing HTA contract under state law); Sack Bros. v. Great Plains Co-op., Inc., 616 N.W.2d 796 (Neb. 2001) (finding HTA contracts to be forward contracts and enforceable under state law). *Cf.* Abels v. Farmers Commodities Corp., 259 F.3d 910, 914-915 (8th Cir. 2001) (discussing nature of hedge-to-arrive contracts); Larson v. Farmers Cooperative Elevator, 211 F.3d 1089 (8th Cir. 2000) (district court held that flex HTA was not a futures contract but the jury was properly instructed that a demand for assurance of performance could be seen as relating to an off-exchange futures transaction).

321 *E.g.*, Lachmund v. ADM Investor Services, Inc., 191 F.3d 777 (7th Cit. 1999) (CFTC amicus brief); In the Matter of Competitive Strategies for Agriculture, Inc., [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,771 (CFTC Initial Decision 1999) (HTA contracts did not fall within forward contract exclusion).

The Commission's aggressive position on hedge-to-arrive contracts has not been unanimous. Commissioner Holum abstained from settlement decisions because she disagreed with the Commission's stance on HTAs.

In the Matter of Farmers Cooperative Co., [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,043 (CFTC Initial Decision 2000) ; In the Matter of Southern Thumb Co-op, Inc., [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,783 (CFTC 1999).

322 Nagel v. ADM Investor Servs., Inc., 65 F. Supp. 2d 740 (N.D. Ill. 1999).

Although a court may decide not to defer to the Commission's view. Once an administrative proceeding is commenced, courts will not interfere by way of injunction; rather, the specified appeals process must be followed. Great Plains Coop v. CFTC, 205 F.3d 253 (8th Cir. 2000) (respondent sought injunction against CFTC action challenging HTA contracts). Appeals from Commission decisions are discussed *infra* §§4.09[39], 4.09[43].

The Nagel decision was affirmed. Nagel v. ADM Investor Services, Inc. 217 F.3d 436 (7th Cir. 2000) (hedge to arrive contracts were forward contracts). In the Nagel decision, Judge Posner applied what has been referred to as a totality of the circumstances test. CFTC v. Zelener, 387 F.3d 624 (7th Cir. 2004) (Ripple, J. dissenting from denial of rehearing *en banc*). *See, e.g.,* Mark D. Young, What's Next After Zelener, 24 Futures & Deriv. Rep. 7 (Feb. 25, 2005); note 330 *infra*. As explained by Judge Ripple in his dissent in Zelener:

> In Nagel, we refined the "totality of circumstances" approach and held that, when the following circumstances are present, a contract will be deemed a forward contract: (1) the contract specifies individualized terms such as place of delivery and quantity, so that the contract is not fungible with other contracts for the sale of the commodity, except for cases in which the seller promises to offset the contract; (2) parties to the contract are industry participants contracting in the commodity rather than non-industry speculators trading for the contract's price; (3) delivery cannot be deferred indefinitely. Nagel, 217 F.3d at 441. We noted that, if one or more of these features is missing, the contract may or may not be a futures contract. *Id.* The circuits that have addressed this question follow a similar approach.

387 F.3d at 626.

323 *See* CFTC v. Midland Rare Coin Exchange, Inc., 71 F. Supp. 2d 1257 (S.D. Fla. 1999).

324 *Id.*

325 Nagel v. ADM Investor Services, Inc., 217 F.3d 436 (7th Cir. 2000).

326 Sack Bros. v. Tri-Valley Co-op., Inc., 616 N.W.2d 786 (Neb. 2001) ; Sack Bros. v. Great Plains Co-op., Inc., 616 N.W.2d 796 (Neb. 2001).

327 Sack Bros. v. Great Plains Co-op., Inc., 616 N.W.2d 796 (Neb. 2001).

328 217 F.3d 436, 441 (7th Cir. 2000).

329 *Id*. at 441, relying on Lachmund v. ADM Investor Services, Inc., 191 F.3d 777, 788-790 (7th Cir. 1999); Grain Land Coop v. Kar Kim Farms, Inc., 199 F.3d 983, 990-992 (8th Cir. 1999); Andersons, Inc. v. Horton Farms, Inc., *supra*, 166 F.3d 308, 317-322 (6th Cir. 1998); CFTC v. Noble Metals Int'l, Inc., *supra*, 67 F.3d 766, 772-773 (9th Cir. 1995); CFTC v. Co Petro Marketing Group, Inc., 680 F.2d 573 579-581 (9th Cir. 1982); Top of Iowa Coop. v. Sime Farms, Inc., 608 N.W.2d 454, 465 (Iowa 2000): *See also* In re Bybee, 945 F.2d 309, 313 (9th Cir. 1991).

330 Nagel v. ADM Investor Services, Inc., 217 F.3d 436, 441 (7th Cir. 2000).

331 *Id.* ("This refinement of the ‘totality of circumstances’ approach that we adopt today, while it will not resolve every case, will protect forward contracts from the sword of Damocles that these plaintiffs wish to wave above the defendants' heads, yet at the same time will prevent evasion of the Commodity Exchange Act by mere clever draftsmanship.").

331.1 CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004).

331.2 *But see* the dissent of Judge Ripple in CFTC v. Zelener, 387 F.3d 624 (7th Cir. 2004) (Ripple, J. dissenting from denial of rehearing *en banc*).

331.3 CFTC v. Zelener, 373 F.3d 861, 864–865 (7th Cir. 2004):

> Instead of trying to parse language in earlier decisions that do not wholly fit this situation, we start with the statute itself. Section 2(a)(1)(A) speaks of "contracts of sale of a commodity for future delivery." That language cannot sensibly refer to all contracts in which settlement lies ahead; then it would encompass most executory contracts. The Commission concedes that it has a more restricted scope, that it does not mean anything like "all executory contracts not excluded as forward contracts by § 1a(19)." What if there were no § 1a(19) ? Until 1936 that exemption was limited to deferred delivery of crops. (Compare the Grain Futures Act of 1922, 42 Stat. 998 (1922), with the Commodity Exchange Act of 1936, 49 Stat. 1491 (1936).) Then until 1936 a contract to deliver heating oil in the winter would have been a "futures contract," and only a futures commission merchant could have been in the oil business! (Moreover, those contracts could have been secured only on boards of trade, because with rare exceptions, such as foreign currency under the Treasury Amendment, all futures contracts must be traded on exchanges or not at all.) Can it be that until 1936 all commercial contracts for future delivery of newspapers, magazines, coal, ice, oil, gas, milk, bread, electricity, and so on were unlawful futures contracts? Surely the answer is no, which means that "contract for future delivery" must have a technical rather than a lay meaning.

331.4 373 F.3d at 366–367:

> Any contention that it is appropriate to ignore the contract's form and focus on economic effects-here, that rollover without full payment (AlaronFX allows customers to use margin while positions are open) can give the buyer the economic equivalent of a long position on a futures exchange-produces a sense of *déjà vu.* We've been here before, but in securities rather than commodities law. A business can be transferred two ways: the corporation may sell all of its assets, then liquidate and distribute to investors the cash received from the buyer; or the investors may sell their securities directly to the buyers. With sufficient care in drafting, these two forms may be made economically equivalent. This equivalence led to arguments that the sale of stock to transfer a whole business should not be regulated by the federal securities laws. Because the sale of assets would be governed by state contract law, it would upset expectations to handle the functionally equivalent transaction under federal law just because stock played a role. Many courts adopted this sale-of-business doctrine, but the Supreme Court rejected it, ruling that form must be respected. See Landreth Timber Co. v. Landreth, 471 U.S. 681, 105 S.Ct. 2297, 85 L.Ed.2d 692 (1985). One reason is that the securities laws are *about* form, and one can say much the same about the commodities laws. Another powerful reason was the need for certainty. The sale-of-business doctrine led to all sorts of questions. What if there were a significant minority shareholder? What if the new buyer did not plan to run the business as an entrepreneur? The list of questions turned out to be long and the uncertainty considerable—just as the CFTC's list of factors has made it hard to determine when rollovers turn spot or forward deals into futures contracts. By taking form seriously the Supreme Court was able to curtail, if not eliminate, that uncertainty and promote sensible business planning. See also Reves v. Ernst & Young, 494 U.S. 56, 110 S.Ct. 945, 108 L.Ed.2d 47 (1990) (simplifying the approach to determining when notes are securities). Since the main battle in the sale-of-business cases was whether fraud litigation would occur in state or federal court, the Justices saw no reason for prolonged litigation about the forum: fraud is illegal in every state. So, too, for the definition of futures contracts. The Commission's principal substantive contention is that BCG deceived its clients. That could form

> the basis of a mail-fraud or wire-fraud prosecution, a civil or criminal action under RICO, or fraud litigation in state court. Consumers or state attorneys general could invoke consumer-protection laws as well. It is unnecessary to classify the transactions as futures contracts in order to provide remedies for deceit. Why stretch the Commodity Futures Act—with resulting uncertainty, litigation costs, and potentially unhappy consequences for other economic arrangements that may be swept into a regulatory system not designed for them—when other remedies are ready to hand? Recognition that futures markets are characterized by trading "in the contract" leads to an easy answer for most situations. Customers of foreign exchange at AlaronFX did not purchase identical contracts: each was unique in amount of currency (while normal futures contracts are for fixed quantities, such as 1,000 bushels of wheat or 100 times the price of the Standard & Poors 500 Index) and in timing (while normal futures contracts have defined expiration or delivery dates). Thus the trade was "in the commodity" rather than "in the contract." Cf. Marine Bank v. Weaver, 455 U.S. 551, 102 S.Ct. 1220, 71 L.Ed.2d 409 (1982) (a non-fungible contract that could not be traded on an exchange is not a security); Giuffre Organization, Ltd. v. Euromotorsport Racing, Inc., 141 F.3d 1216 (7th Cir.1998) (a sports franchise linked to a single owner is not a security).

331.5 CFTC v. Erskine, 512 F.3d 309 (6th Cir. 2008) (foreign currency transactions were forward contracts rather than futures contracts as had been urged by the CFTC); CFTC v. Uforex Consulting, LLC, 551 F. Supp. 2d 513 (W.D. La. 2008) (rejecting CFTC's position and finding that foreign currency transactions were not futures contracts subject to CFTC jurisdiction).

331.6 CFTC v. White Pine Trust Corp. 574 F.3d 1219 (9th Cir. 2009).

331.7 7 U.S.C. §2(c)(2)(B)(i), CCH Rep. ¶1023; CFTC v. White Pine Trust Corp. 574 F.3d 1219, 1226 (9th Cir. 2009) ("Subsection 2(c)(2)(B)(i) gives the CFTC jurisdiction in this context only over 'an agreement, contract, or transaction in foreign currency that is…an option [and]…is offered to' a retail customer.").

331.8 CFTC v. White Pine Trust Corp. 574 F.3d 1219, 1227 (9th Cir. 2009):

> We are persuaded that neither subsection 2(c)(2)(B) nor subsection 6c(b) grants the CFTC jurisdiction over discretionary trading accounts in foreign currency options. Congress may well have considered providing jurisdiction to the CFTC over fraudulent solicitations of the kind at issue here. But the CFTC has not been able to point to any language in the Act that bears such interpretation. Therefore, we must conclude that it does not have power to bring this action.

331.9 *Id.*

332 OTC securities options are known to have existed at the time of enactment of the Securities Exchange Act of 1934. *See* Becker and Burns: Regulation of Exchange-Traded Options, in The Handbook of Derivatives & Synthetics (Klein and Lederman, eds. 1994).

333 Principally the Securities Act of 1933, 15 U.S.C. §§77a *et seq.* and the Securities Exchange Act of 1934, 15 U.S.C. §§78a *et seq.*

334 *See* 17 C.F.R. §§240.0-1 *et seq.*

335 The SEC's jurisdiction over some securities options was thrown into confusion when the U.S. Court of Appeals for the Seventh Circuit ruled in Board of Trade of the City of Chicago v. SEC, 677 F.2d 1137 (7th Cir. 1982), reprinted at [1980-1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 21,365, that the CFTC had exclusive jurisdiction over options on Government National Mortgage Ass'n (GNMA) securities because futures were already trading on GNMAs, thus making them "commodities."

336 *See* Securities Exchange Act Release No. 9985 (Feb. 1, 1973).

337 *See* Securities Exchange Act §§19(6) and 19(6), 15 U.S.C. §§78i(b) and 78s(b), and SEC Rules 9b-1, 19b-4, and 19c-5, 17-C.F.R. §§240.9b-1, 240.19b-4, and 240.19c-5. For discussion of securities regulation generally,

see Thomas Lee Hazen, Treatise on the Law of Securities Regulation (Practitioner's Ed. 4th ed. 2002). For discussion relating to hybrid instruments, *see* 1 *id.* §§1.5, 1.7.

338 For the NASD Rules *see* www.nasdr.com.

339 The private placement exemption from registration under the Securities Act of 1933 is found in Securities Act §4(2), 15 U.S.C. §77d(2). *See* 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §4.24 (Practitioner's Ed. 4th ed. 2002).

340 Golden Nugget, Inc. v. American Stock Exchange, Inc. 828 F.2d 586 (9th Cir. 1987).

341 The potential for overlap exists between securities options, which are generally lawful under SEC rules, and securities futures, which are now permitted under the Commodity Exchange Act. The overlap exists because securities futures can be formed "synthetically" by a combination of securities options. For example, the equivalent of a "long" securities futures position can be created by purchasing a securities call option (enjoying upside gain) and writing a securities put option (suffering downside loss) at or about the same strike price. Conversely, the equivalent of a "short" securities futures contract can be synthesized by buying a securities put option and writing a securities call option at or about the same strike price.

As explained above, futures contracts on individual securities formerly were unlawful under the Commodity Exchange Act if the underlying security was not exempt from SEC registration or was a municipal security. The CFTC decided to perform analyses of any securities options with respect to their economic behavior vis-à-vis a futures contract. However, comparisons between a series of options and a futures contract typically focus on whether they behave economically in a substantially similar manner. Significantly different strike prices for the options, as well as markedly different terms, may cause the "pair" to perform in a quite different manner from a futures contract and thus reduce the risk of being classified as a synthetic futures contract. Prior to the amendments in the year 2000 that permitted trading on individual equity securities, the legal outcomes would have been strikingly different when the transaction is viewed as a lawful series of securities options rather than a prohibited securities futures contract. While the matter was not litigated, the decision to portray the transaction as a series of permissible securities options at or about the same strike price was not without legal risk prior to the amendments to the Act ushered in by the CFMA, especially in the absence of other distinctions causing the series to behave economically in a significantly different manner from a futures contract, if the congressional ban on most securities futures were to have been given any practical effect. *See* CFTC Interpretative Letter No. 94-32 (Status of Financial Instruments Indexed to Individual Stocks), [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 126,042 (Feb. 4, 1994).

342 *See* OTC Derivative Dealers, 63 Fed. Reg. 59,362-01, 1998 WL 760754 (F.R.) (SEC Nov. 3, 1998).

343 *See* CFTC Says Sec Has no Right to Implement "Broker-Dealer Lite," 30 Sec. Reg. & L. Rep. (BNA) 379 (Mar. 6, 1998).

344 17 C.F.R. §240.3b-13. The OTC derivatives dealers registration requirements are contained in Rules 3b-12 through 3b-15. 17 C.F.R. §§240.3b-12 - 240.3b-15.

345 These activities are described in SEC Rule 3b-14, 17 C.F.R. §240.3b-14.

346 *See* SEC Rule 3b-15, 17 C.F.R. §240.3b-15.

347 *See, e.g.*, Willa E. Gibson, Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions, 24 J. Corp. L. 381 (1999).

348 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). The CFMA is discussed in greater detail in other sections of this Treatise; *see, e.g.*, *supra* §§1.02[8][F], 1.02[9].

349 Some of the indexes trading prior to the CFMA might not have qualified as broad-based indexes under the amended Act. Accordingly, the CFTC and the SEC issued a joint order grandfathering those existing contracts as broad-based indexes by excluding them from the category of narrow-based indexes. *See* Joint Order Regarding the Definition of Narrow-Based Security Index Those Security Indexes That Qualified for the Exclusion From That Definition Under Section 1A(25)(b)(v) of the Commodity Exchange Act and Section 3(a)(55)(c)(V) of the Securities Exchange Act of 1934, Sec. Act Rel. No. 33-46009, 2002 WL 1114177 (SEC/CFTC May 31, 2002). *See also, e.g.,* CFTC-SEC Joint Order Excluding Indexes Comprised of Certain Index Options

From the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(Vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(Vi) of the Securities Exchange Act Of 1934, Sec. Exch. Act Rel. No. 49469, Release No. 34-49469, 82 S.E.C. Docket 1811, 2004WL 598172 (SEC Mar. 25, 2004).

350 Regs. §§41.42 - 41.49, 17 C.F.R. §§41.41 - 41.49, CCH Rep. ¶ 2909A-2909H; Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. 53146-01, 2002 WL 1840540 (CFTC Aug. 14, 2002). The margin requirements are discussed *infra* §§1.03[13], 2.06[2].

351 7 U.S.C. §1a(25), CCH Rep. ¶ 1002.

352 Section 2(a)(1)(C)(ii), 7 U.S.C. §2(a)(1)(C)(ii), CCH Rep. ¶ 1023.

353 7 U.S.C. §2(a)(1)(A)(ii) (amended 2000).

354 For further discussion, *see infra* §4.05[8].

355 803 F.2d 1242 (2d Cir. 1986), reprinted at [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) 123,318.

356 58 F.3d 50 (2d Cir. 1995), reprinted at [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,429, rev'd, 117 S. Ct. 913 (1997).

357 CFTC v. Dunn, 519 U.S. 465 (1997).

358 8 F.3d 966 (4th Cir. 1993), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,872.

359 8 F.3d at 997.

360 8 F.3d at 973, n.5.

361 1993 U.S. Dist. LEXIS 19909 (E.D.N.Y. 1993), reprinted at [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CC I1)1 26,063.

362 *Id.* at CCH ¶ 26,063, p.41,455.

363 1995 U.S. Dist. LEXIS 12716 (N.D. Cal. 1995).

364 CFTC v. Frankwell Bullion Ltd., 99 F.3d 299 (9th Cir. 1996).

365 Dunn v. CFTC, 519 U.S. 465 (1997). *See also, e.g.*, In the Matter of Global Link Miami Corp., [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,669 (CFTC 1999), *rev'g* [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,391 (CFTC Initial Dec. 1997) (foreign currency futures transactions—i.e., currency swaps—were traded on a "board of trade" and thus subject to CFTC jurisdiction even though organized futures exchange).

366 Justice Scalia, concurring, disavowed any need for reference to the legislative history, reasoning that the language of the statute belied any claim that it did not apply to options transactions.

367 DuBois v. Alai-on Trading Corp., [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,061 (CFTC Initial Dec. 1997). *See also* Dubois v. Alaron Trading Corp., [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,406 (CFTC 2000) (transactions were not excluded under Treasury Amendment since respondent's advertising and promotional material indicated that small and medium sized investors could gain access to global currency market through its trading facility, and nothing indicated that complainant was sophisticated institutional trader eligible to trade on interbank market).

368 Rossner v. Peregrine Fin., Inc., 30 Sec. Reg. & L. Rep. (BNA) 864 (S.D.N.Y. 1998). Judge Duffy found the reasoning of the court in CFTC v. Standard Forex, [1992-1994 Transfer Binder] Comet. Fut. L. Rep. (CCH)11 26,063 (E.D.N.Y. 1993) more persuasive than that of CFTC v. Frankwell Bullion, 99 F.3d 9th Cir. 1996), holding that transactions conducted on a board of trade mean only on-exchange trades). *See* 30 Sec. Reg. & L. Rep. (BNA) 864. Judge Duffy further said that the Treasury Amendment was not intended to exempt all off-exchange transactions but only those interbank transactions that are subject to government regulation. *Id. See also, e.g.*, Thomas A. Tormey, Note, A Derivatives Dilemma: The Treasury Amendment Controversy and the Regulatory Status of Foreign Currency Options, 65 Fordham L. Rev. 2313 (1997).

369 de Kwiatkowski v. Bear Stears & Co., [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CC FI) 127,224, 1997 WL 538819 (S.D.N.Y. 1997). For subsequent history in the case, decided on other grounds, *see* de Kwiatkowski v. Bear Stears & Co., 306 F.3d 1293 (2d Cir. 2002), *rev'g* 126 F.Supp.2d 672 (S.D.N.Y. 2000).

370 Rosner v. Peregrine Fin. Ltd., [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,342-27,343 (S.D.N.Y. May 18, 1998) (handling of trades in omnibus account could be characterized as on a board of trade).

371 In the Matter of Global Link Miami Corp., [Current] Comm. Fut. L. Rep. (CCH) ¶ 27,669 (CFTC 1999), reversing [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,391 (CFTC Initial Dec. 1997).

372 278 F.3d 319, 327-329 (4th Cir. 2002). *See also* Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 118, 156-157 (S.D.N.Y. 2000) ("conducted on a board of trade" encompasses not only transactions conducted on formally organized futures exchanges, but also other trades as long as they were not conducted between two banks).

373 *See, e.g.*, 59 Fed. Reg. 54,139 (Oct. 28, 1994), reprinted at [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,243 discussing separate petitions to the CFTC by two major contract markets for relief from the on-exchange and other Act requirements for certain currency transactions and for institutional participants generally. In response, the CFTC has adopted new Part 36 to its Regulations, 17 C.F.R. §§36.1 *et seq.*, providing relief to contract markets where "eligible participants" are involved, dealing in limited ways with competitive trading requirements, listing procedures, risk disclosure and registration but otherwise requiring full Act compliance.

374 Over-the-Counter Derivatives Markets and Commodity Exchange Act: Report of the President's Working Group on Financial Markets, at 24-27 (November 1999).

375 These changes are codified in section 2(c) of the Act, 7 U.S.C. §2(c), CCH Rep. ¶ 1023.

376 7 U.S.C. §1a(12), CCH Rep. ¶ 1002.

377 7 U.S.C. §1a(13), CCH Rep. ¶ 1002.

378 Section 2(d), 7 U.S.C. §2(d), CCH Rep. ¶ 1024.

379 17 C.F.R. §§36.1 *et seq. See supra* §§1.02[2], 1.02[5].

380 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000).

381 As defined in section 1a(12) of the Act, 7 U.S.C. §1a(12), CCH Rep. ¶ 1002.

381.1 *See* Rebecca Holz, Trading Volume: A Remarkable Start in 2006, Futures Industry, available at http://www.futuresindustry.org/fimagazi-1929.asp?iss=167=1116. Global futures and options volume reached 1.9 billion contracts, up 34.3% over the same period last year.

382 *See* section 4c(b) of the Act, 7 U.S.C. §6c(b), CCH Rep. ¶ 1051, and Reg. §32.11, 17 C.F.R. §32.11, CCH Rep. ¶ 2731.

383 Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). *Compare, e.g.*, Lynne A Stout, Derivatives and the Legal Origins of the Credit Crisis, 1 Harv. Bus. L. Rev. 1 (2011) (arguing that the CFMA was a cause of the 2008 credit crisis) *and* Frank D'Souza, Nan S. Ellis & Lisa M. Fairchild, Illuminating the Need for Regulation in Dark Markets: Proposed Regulation of the OTC Derivatives Market, 12 U. Pa. J. Bus. L. 473, 485 (2010) (calling for regulation of the OTC derivatives markets) *with* Alireza M. Gharagozlou, Why Derivatives May Never be Regulated, 4 Brook. J. Corp. Fin. & Comm. Law 269 (2010) (arguing that derivatives may never be effectively regulated). *See also, e.g.,* Thomas Lee Hazen, Filling a Regulatory Gap: It Is Time To Regulate Over-The-Counter Derivatives, 13 N.C. Banking Inst. 123 (2009); Thomas Lee Hazen, Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insuranc *e,* 24 Ann. Rev. of Banking & Fin. L. 375 (2005).

384 The new permission for off-exchange contracts is not to be applied retroactively. Cary Oil Co. v. MG Refining & Marketing, Inc., 230 F. Supp. 2d 439 (S.D.N.Y. 2002).

385 The 2000 amendments to the Commodity Exchange Act thus introduced a new category of eligible contract participants (ECPs) consisting of institutional and highly accredited customers. Section 1a(12), 7 U.S.C. §1a(12), CCH Rep. ¶ 1002, CFMA §101. *See infra* §1.18[5]. Access to DTEFs must be confined to ECPs or to non-ECPs who (1) trade through a futures commission merchant that is registered with the CFTC; (2) are members of a registered futures association (or, in the case of security futures products, a registered

securities association); (3) are clearing members of a derivatives clearing organization; and (4) have net capital of at least $20 million. Section 5a(b)(3), 7 U.S.C. §7a(b)(3), CCH Rep. ¶ 1207B, CFMA §111.

386 Section 5a(b)(3), 7 U.S.C. §7a(b)(3), CCH Rep. ¶ 1207C, CFMA §111.

387 Section 5d, 7 U.S.C. §7a-3, CCH Rep. ¶¶ 1230-1236.

388 7 U.S.C. §1a(4), CCH Rep. ¶ 1002.

389 An example of a "commodity" for which there is no cash (physical) market where it is traded directly would be futures or options on certain natural phenomena or contingencies.

390 Codified in section 5b, 7 U.S.C. §7a-1, CCH Rep. ¶¶ 1213-1220.

391 For definition of "security future" and "security future product" *see* sections 1a(31), (32), 7 U.S.C. §§1a(31), (32), CCH Rep. ¶ 1002. *See also* Section 5f, 7 U.S.C. §7f, CCH Rep. ¶ 1238 (designation of securities exchanges and associations as a board of trade).

392 For discussion of the SEC's margin requirements, *see* Thomas Lee Hazen, Treatise on the Law of Securities Regulation §14.9 (4th ed. 2002); Jerry W. Markham & Thomas L. Hazen, Broker-Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection, ch. 3 (2001).

393 Section 31 of the Securities Exchange Act of 1934, 15 U.S.C. 78ee.

394 Coauthor Johnson recalls that the Chicago Board of Trade's research staff drew the same conclusion in the early 1970s when it formed the Chicago Board Options Exchange (CBOE).

395 Nasdaq LIFFE Markets (NQLX) and OneChicago Exchange were formed following the enactment of the Commodity Futures Modernization Act of 2000 and began trading in the fall of 2002. Nasdaq has since withdrawn as a partner in NQLX.

395.1 15 U.S.C. §§77b-1(b)(1), 78c-1(b)(1) (both of which exclude “security-based swap agreements” from the definition of “security”), added by Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). *See also* 15 U.S.C.A. §§77b-1(a), 78c-1(a) (excluding “non-security-based swap agreements” from the definition of “security”). *Cf.* K3C Inc. v. Bank of America, N.A., 204 Fed. Appx. 455, 465 (5th Cir. 2006) (interest rate swaps were not securities under the Texas Securities Act), relying on Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270, 1277–83 (S.D. Ohio 1996) and Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 159, 164, 167 (S.D.N.Y. 2001).

Notwithstanding the exclusion of security-based or equity swaps from the definition of security, where a swap is used to garner control and at the same time evade SEC filing provisions that would otherwise be implicated, the filing may nevertheless be required. *See* CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 2008 WL 2372693 (S.D.N.Y. June 11, 2008) (“Rule 13d-3(b) under the Exchange Act provides in substance that one who creates an arrangement that prevents the vesting of beneficial ownership as part of a plan or scheme to avoid the disclosure that would have been required if the actor bought the stock outright is deemed to be a beneficial owner of those shares. That is exactly what the defendants did here in amassing their swap positions. In consequence, defendants are deemed to be the beneficial owners of the referenced shares.”). The *CSX* case was the first to address the problem of decoupling ownership and voting control through the use of equity swap arrangements. This has been an increasingly popular device used by hedge funds to try to garner more voting power without making the total investment necessary for outright stock ownership. *See* Henry T.C. Hu & Bernard Black, Equity and Debt Decoupling and Empty Voting II: Importance and Extensions, 156 U. Pa. L. Rev. 625 (2008); Henry T. C. Hu & Bernard Black, Hedge Funds, Insiders, and the Decoupling of Economic and Voting Ownership: Empty Voting and Hidden (Morphable) Ownership, 13 J. Corp. Fin. 343 (2007); Henry T.C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 61 Bus. Law. 1011 (2006); Henry T.C. Hu & Bernard Black, Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms, 79 S. Cal. L. Rev. 811 (2006). This has been referred to as “empty voting.” *Id.*

395.2 *See, e.g.*, 15 U.S.C. §77q(a), 78i(a), 78j(b), as amended by Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000). Swaps are discussed in §1.02[12A] *infra*.

396 Some of the indexes trading prior to the CFMA might not have qualified as broad-based indexes under the amended Act. Accordingly, the CFTC and the SEC issued a joint order grandfathering those existing contracts as broad-based indexes by excluding them from the category of narrow-based indexes. *See* Joint Order Regarding the Definition of Narrow-Based Security Index Those Security Indexes That Qualified for the Exclusion From That Definition Under Section 1A(25)(b)(v) of the Commodity Exchange Act and Section 3(a)(55)(c)(V) of the Securities Exchange Act of 1934, Sec. Act Rel. No. 33-46009, 2002 WL 1114177 (SEC/CFTC May 31, 2002). *See also* Reg. §41.21(b), 17 C.F.R. §41.21(b), CCH Rep. ¶ 2895, for the listing criteria applicable to narrow based indexes.

396.1 *See, e.g.,* CFTC-SEC Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(Vi) of the Commodity Exchange Act and Section 3(a)(55)(C)(Vi) of the Securities Exchange Act of 1934, Sec. Exch. Act Rel. No. 34-49469, Release No. 34-49469, 82 S.E.C. Docket 1811, 2004 WL 598172 (SEC Mar. 25, 2004).

397 Section 1a(30), 7 U.S.C. §1a(30), CCH Rep. ¶ 1002, CFMA §101.

398 Section 3(a)(55)(B) of Securities Exchange Act, 15 U.S.C. §78c(a)(55)(B).

399 The curious use of the term "future" (singular) rather than the traditional word "futures" that appears otherwise throughout the Act provoked co-author Johnson to include in his regular column for the London-based *Futures & OTC World* (September 2002) an article entitled "There' omething mi ing."

399.1 The SEC has allowed U.S. qualified institutional buyers as well as foreign investors to trade in foreign securities futures without registration. *See* Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption From Exchange Act Section 6(h)(1) for Certain Persons Effecting Transactions in Foreign Security Futures and Under Exchange Act Section 15(a)(2) and Section 36 Granting Exemptions From Exchange Act Section 15(a)(1) and Certain Other Requirements, 74 Fed. Reg. 32200-01, 2009 WL 1916196 (SEC July 7, 2009) (permitting trading under SEC 1933 Act Rule 144A). *See also, e.g.,* Eric J. Pan, Single Stock Futures and Cross-Border Access for U.S. Investors, 14 Stan. J.L. Bus. & Fin. 221 (2008).

400 Section 1a(25), 7 U.S.C. §1a(25), CCH Rep. ¶ 1002, CFMA §101.

401 *See also* Method for Determining Market Capitalization and Dollar Value of Average Daily Trading Volume; Application of the Definition of Narrow-Based Security Index, Sec. Exch. Act Rel. No. 34-44288 (CFTC & SEC May 10, 2001) (jointly proposed rules). *See also, e.g.*, CFTC-SEC Joint Order Excluding Indexes Comprised of Certain Index Options from the Definition of Narrow-Based Security Index Pursuant to Section 1a(25)(B)(Vi) of the Commodity Exchange Act and Section 3(a)(55)(C) (Vi) of the Securities Exchange Act Of 1934, Sec. Exch. Act Rel. No. 49469, Release No. 34-49469, 82 S.E.C. Docket 1811, 2004 WL 598172 (SEC Mar. 25, 2004).

402 15 U.S.C. §78 *l.*

403 The term "broad-based" will not be found in either the Act or in any federal securities legislation but is used colloquially by the industry to mean any index that falls outside the Act's explicit definition of "narrow-based."

404 State gambling laws and blue sky laws are preempted with respect to stock futures.

405 15 U.S.C. §78 *l.* CFTC Regulation section 41.22 provides that it is unlawful for a designated contract market or derivatives transaction execution facility unless the Commission is provided with a certification that the SFP and the board of trade listing the product meet the statutory criteria. Reg. §41.22, 17 C.F.R. §41.22, CCH Rep. ¶ 2896. *See infra* §2.03[12] for discussion of listing standards for security futures products.

406 Registration under section 12 of the Exchange Act subjects the issuer of those securities to various regulatory requirements including detailed periodic reporting requirements of the company's operations. For discussion of the registration and periodic reporting requirements, *see* Thomas Lee Hazen, Treatise on the Law of Securities Regulation ch. 9 (4th ed. 2002).

407 *See* Registration of National Securities Exchanges Pursuant to Section 6(g) of the Securities Exchange Act of 1934 and Proposed Rule Changes of National Securities Exchanges and Limited Purpose National Securities Associations, Sec. Exch. Act Rel. No. 34-44279 (SEC May 10, 2001).

408 *See* Proposed Rules to Provide for Notice Registration as a Futures Commission Merchant or Introducing Broker for Securities Broker-Dealers Trading Security Futures Products, CFTC Rel. No. 4517-01 (CFTC May 17, 2001).

409 7 U.S.C. §2(a)(1)(D)(i)(V), CCH Rep. ¶ 1011B.

410 *Id.* For discussion of the National Association of Securities Dealers' suitability requirements, *see* Thomas Lee Hazen, Treatise on the Law of Securities Regulation §14.16 (4th ed. 2002).

411 *See infra* §5.09[11] for discussion of suitability.

412 For discussion of Investment adviser regulation *see* Thomas Lee Hazen, Treatise on the Law of Securities Regulation ch. 21 (4th ed. 2002).

413 Designated Contract Markets in Security Futures Products: Notice-Designation Requirements, Continuing Obligations, Applications for Exemptive Orders, and Exempt Provisions (Proposed Rulemaking) 66 FR 29517-01, 2001 WL 577768 (F.R.) footnote 6 (CFTC May 31, 2001).

414 For a description of the problems engendered by dual trading on the futures markets *see* Jerry W. Markham, *Prohibited Floor Trading Activities Under the Commodity Exchange Act*, 58 Fordham L. Rev. 1 (1989).

415 15 U.S.C. §78k-1(e)(1), CCH Rep. ¶ 1855, CFMA §206(c).

416 15 U.S.C. §78k-1(e)(1), CCH Rep. ¶ 1855, CFMA §206(c).

417 Section 2(a)(1)(E)(i), 7 U.S.C. §2, CCH Rep. ¶ 1011C, CFMA §251.

418 15 U.S.C. §78bb(a) (as amended by CFMA §210, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)). *See also* CEA §12(e)(2), 7 U.S.C. §16(e)(2), CCH Rep. ¶ 1371 (as amended by CFMA §117, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)).

419 15 U.S.C. §78bb(a) (as amended by CFMA §210, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)).

420 7 U.S.C. §16(e)(2), CCH Rep. ¶ 1371 (as amended by CFMA §117, Pub. Law No. 106-554, 114 Stat. 2763 (Dec. 21, 2000)). The SEC and CFTC adopted joint rules on the margin requirements for security futures products. *See* Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. 53146-01, 2002 WL 1840540 (CFTC, SEC Aug. 14, 2002).

421 15 U.S.C. §78j(a)(2) (specifically excluding security futures products from the Securities Exchange Act's short sale provisions).

422 *See* CFTC Final Rules Provide Notice-Designation Procedures for Securities Exchanges That Plan to Trade Single-Stock Futures August 21, 2001 WL 943789 (CFTC Aug. 21, 2001).

423 The SEC and the CFTC are authorized to act "jointly" to grant exemptions under certain circumstances. Compliance with this requirement is delayed until a date set in the future jointly by the SEC and CFTC. The date for compliance must be the later of two years after trading first begins in any stock futures or 180 days after certain total trading volume in stock futures based on single equities, as compared to total trading volume in options on single equity securities, is reached. In 2002, the CFTC and SEC jointly issued rules for clearing of SFPs. *See* Cash Settlement and Regulatory Halt Requirements for Security Futures Products, Sec. Exch. Act Rel. No. 34-45956, 67 Fed. Reg. 36740, 2002 WL 1040000 (SEC/CFTC May 24, 2002).

424 In 2002, the Commission adopted Regulation section 41.27 to restrict dual trading by floor brokers in security futures productions traded on an designated contract market or a derivatives transaction execution facility. 17 C.F.R. §41.27, CCH Rep. ¶ 2900. *See* Regulation to Restrict Dual Trading in Security Futures Products, 67 Fed. Reg. 11,223-01, 2002 WL 383985 (CFTC March 13, 2002). The Regulation further permits contract markets and exchange facilities to promulgate rules permitting exceptions from the dual trading prohibition under the specified circumstances. Reg. §41.27(d)(1) - (d)(4), 17 C.F.R. §41.27(d)(1) - (4), CCH Rep. ¶ 2900. *See infra* §1.09[5].

425 *See* Listing Standards and Conditions for Trading Security Futures Products, 66 Fed. Reg. 55,078, 2001 WL 1337418 (CFTC Nov. 1, 2001). Those listing standards are discussed *infra* §2.03[12].

425.1 *See* SEC-CFTC, Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Sec. Exch. Act Rel. No. 34-54106 (SEC-CFTC July 6, 2006). *See also, e.g.*, Kenneth M. Raisler & David J. Gilberg, SEC and CFTC Propose Rules to Permit the Trading of Futures on Debt Indices, 26 Futures & Deriv. L. Rep. 3 (May 2006).

425.2 The applicable rules are CFTC Reg. § 41.21 CCH Rep. ¶ 41.21 and SEC Rules 3a55-4 and 6h-2, 17 C.F.R. §§240.3a55-4, 240.6h-2.

425.3 SEC-CFTC, Joint Final Rules: Application of the Definition of Narrow-Based Security Index to Debt Securities Indexes and Security Futures on Debt Securities, Sec. Exch. Act Rel. No. 34-54106 (SEC-CFTC July 6, 2006).

426 The Securities Investor Protection Corporation (SIPC) and the protections afforded customers of insolvent securities broker-dealers by the Securities Investor Protection Act are discussed in 3 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §14.24 (4th ed. 2002).

427 Section 4d(a)(2), 7 U.S.C. §6d, CCH Rep. ¶ 1071. Historically, the sums of customer funds lost due to FCM bankruptcy have been far smaller than the amounts paid out by SIPC for broker-dealer failures, a fact leading the Commission to conclude that the Commodity Exchange Act's Unique program for segregating customer funds in bank accounts separate from those used by an FCM in its own operations obviated any need for a SIPC-style plan for the futures markets. Report to Congress Concerning Commodities Futures Account Insurance, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,235 (November 1, 1976).

428 Internal Revenue Code §1256.

429 15 U.S.C. §77b(a)(3) (2000).

430 *See* Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Security Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Sec. Act Rel. No. 33-8107, Sec. Exch. Act Rel. No. 34-46101, 67 Fed. Reg. 43233, 2002 WL 1377488 (SEC June 27, 2002). The registration requirements under the 1933 Act are discussed in 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation (Practitioner's Ed. 4th ed.).

431 17 C.F.R. §§242.101 *et seq.*

432 Regulation M is discussed in 1 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §6.2 (Practitioner's Ed. 4th ed. 2002).

433 *See* Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Security Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Sec. Act Rel. No. 33-8107, Sec. Exch. Act Rel. No. 34-46101, 67 Fed. Reg. 43,233, 2002 WL 1377488 (SEC June 27, 2002).

434 17 C.F.R. §240.14e-5.

435 *See* Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Security Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Sec. Act Rel. No. 33-8107, Sec. Exch. Act Rel. No. 34-46101, 67 Fed. Reg. 43233, 2002 WL 1377488 (SEC June 27, 2002).

436 *Id.*

437 15 U.S.C. §78p(a). *See generally* Thomas Lee Hazen, Treatise on the Law of Securities Regulation ch. 13 (Practitioner's Ed. 4th ed. 2002).

438 *See* Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Security Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Sec. Act Rel. No. 33-8107, Sec. Exch. Act Rel. No. 34-46101, 67 Fed. Reg. 43233, 2002 WL 1377488 (SEC June 27, 2002).

439 15 U.S.C. §78n(d). *See* Commission Guidance on the Application of Certain Provisions of the Securities Act of 1933, the Security Exchange Act of 1934, and Rules Thereunder to Trading in Security Futures Products, Sec. Act Rel. No. 33-8107, Sec. Exch. Act Rel. No. 34-46101, 67 Fed. Reg. 43,233, 2002 WL 1377488 (SEC June

27, 2002). Further ownership of security futures products do not count in the long position of the underlying security with respect to short sales and short or hedged tendering until the futures product ceases trading. *Id.*

439.1 This subsection is adapted from Philip McBride Johnson, One "Take" on Single Stock Futures, 25 Futures & Deriv. L. Rep. 22 (Mar. 2005).

439.2 *See* Galen Burghardt, FIA Volume Surges Again: Global Futures and Options Trading Rises 28% in 2007, Futures Industry, available at http://www.futuresindustry.org/fi-magazine-home.asp?a=1242&iss=181. Single stock futures growth occurred largely outside the United States.

440 Reg. §4c, 7 U.S.C. §6c, CCH Rep. ¶¶ 1061-1065.

440.1 *See* CFTC v. White Pine Trust Corp., 574 F.3d 1219, 1225 (9th Cir. 2009) (quoting this treatise).

441 *See* First Am. Discount Corp. v. Jacobs, 324 Ill. App. 3d, 258 Ill. Dec. 291, 756 N.E.2d 273, 274 (2001) (noting that put option gives buyer right to sell contract at fixed, strike price even if market declines below that price, whereas call option gives buyer right to buy at strike price even if market rises above that level).

442 The Commission has identified three criteria for an option: (1) the instrument gives the buyer the right to take or make delivery of the commodity, but does not obligate the buyer to do so; (2) the buyer's losses are limited to a premium paid as consideration for the option seller's performance; and (3) the instrument is purchased by offering a premium, as opposed to a down payment on the eventual delivery price. In the Matter of Cargill, Inc., [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,425 (CFTC 2000) (dismissing allegation of illegal agricultural options). *See also* Blanchard Valley Farmers Cooperative, Inc. v. Carl Niese & Sons Farms, Inc., 143 Ohio App. 3d 795, 801-802, 758 N.E.2d 1238, 1243 (2001) (fact that contract documents identified underlying transactions as calls or puts and appeared to be at least partially speculative in nature rather than contemplating fixed obligations on both parties raised genuine issue of material fact as to whether contracts were illegal off-exchange options).

443 *See e.g.*, Hearings before the Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition and Forestry, 95th Cong., 2d Sess. 611-620 (March 1978).

444 7 U.S.C. §6c(c), CCH Rep. ¶ 1063. Before 1981, option trading in American futures contracts had been barred by Reg. §32.11, and the Act also prohibited any form of commodity options in the agricultural products now itemized in §1 a of the Act. *See* Futures Trading Act of 1982, Pub. L. No. 97-444, 96 Stat. 2294 (Jan. 11, 1983).

445 17 C.F.R. §§33.1 - 33.11, CCH Rep. ¶ 2743-2751.

446 52 Fed. Reg. 777 (1987); 46 Fed. Reg. 33,293 (1981).

447 7 U.S.C. §6c, CCH Rep. ¶ 1063.

448 17 C.F.R. §32.11, CCH Rep. ¶ 2372.

449 The Commission adopted Part 30 of its Regulations, which authorizes domestic sales of foreign futures under strict conditions (previously there were no restrictions) and opens the way for United States investors to trade in foreign commodity option contracts for the first time since 1978. 17 C.F.R. §§30.1 - 30.11, CCH Rep. TT 2701-2707. *See* 52 Fed. Reg. 28,980, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,740 (Aug. 5, 1987). *See also infra* §3.05[8].

450 For an extensive description of the Commission's actions against option dealers, *see* 43 Fed. Reg. 16,153, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,588 (April 17, 1978). Typical of actions taken by other law enforcement agencies are SEC v. Continental Comm. Corp., 497 F.2d 516 (5th Cir. 1974) (the SEC), and Kelley v. Carr, 442 F. Supp. 346 (W.D. Mich. 1977) (state enforcement).

451 *See infra* §§3.05[1] - 3.05[8]. *See also, e.g.*, Edwards v. American Options Corp., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,854 (CFTC 1979) (reparations), and Gravois v. Fairchild, Arabatzis, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,706 (CFTC 1978) (civil litigation).

452 61 Fed. Reg. 10,891 (Mar. 18, 1996), reprinted at [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,642. See Reg. §30.3(a), 17 C.F.R. §30.3(a), CCH Rep. 12702. *See, e.g.*, Foreign Option Transactions, 57 Fed. Reg. 2675, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,213 (CFTC Jan. 23, 1992)

(authorizing United States trading in option contracts on the Nikkei Stock Average Futures Contract traded on the Singapore International Monetary Exchange); Foreign Futures and Option Transactions, 56 Fed. Reg. 66,345, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,178 (CFTC Dec. 23, 1991) (permitting option contracts based on certain futures contracts traded on the Marche à Terme International de France).

453 17 C.F.R. § 32.4 (2010).

454 77 Fed. Reg. 25320 (Apr. 27, 2012).

[455-474][Reserved.]

475 Section 19, 7 U.S.C. §23, CCH Rep. ¶ 1451; Regs. Part 31, 17 C.F.R. Part 31, CCH Rep. ¶¶ 2711A-2714.

476 In adopting its leverage transaction rules the Commission did not define leverage and ban everything else but said simply that whatever does not fit the definition is not "leverage" and may be regulated or prohibited by any other authority as it sees fit. *See* 49 Fed. Reg. 5498, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,005, at pp. 28,412-28,413 (Feb. 13, 1984).

Cf. CFTC v. American Precious Metals, LLC, 845 F. Supp. 2d 1279 (S.D. Fla. 2011) (telemarketer purporting to sell physical gold, silver, platinum, and palladium using a "leverage program" was not offering leverage contracts within the meaning of the Act).

477 Reg. §31.20, 17 C.F.R. §31.20, CCH Rep. 12713E (prohibition of guarantees against loss). The Commission had proposed a requirement that LTMs continually offer to repurchase leverage contracts sold to their customers. In response to opposition the Commission relaxed the requirement to prohibit LTMs from offering leverage contracts at a time when they are not offering to repurchase similar contracts from their customers. 49 Fed. Reg. 5498, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,005, at p.28,449 (Feb. 13, 1984).

478 Reg. §31.8, 17 C.F.R. §31.8, CCH Rep. ¶ 2711 E.

479 *See, e.g.*, excerpts from the Report of the Commission's Advisory Committee on the Definition and Regulation of Market Instruments, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,192 (1976).

480 Pub. L. 93-463, 88 Stat. 1389 *et seq.* (1974). Section 217 was not made formally a part of the Commodity Exchange Act at that time but stood as a separate statute until it was absorbed into the Act, as §19 (7 U.S.C. §23) in 1978.

481 Section 217 and its successor, section 19 of the Act (7 U.S.C. §23), refer to Regulations to be adopted by the Commission "to ensure the financial solvency of the transaction or prevent manipulation or fraud."

482 Pub. L. 93-463, 88 Stat. 1389 *et seq.* (1974).

483 17 C.F.R. §31.3, CCH Rep. ¶ 2711.

484 7 U.S.C. §23, CCH Rep. ¶ 1451.

485 43 Fed. Reg. 56,885, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,704, at pp. 22,859-22,863 (Dec. 5, 1978).

486 17 C.F.R. §31.1, (1978). Another two-year moratorium was imposed by Congress in 1986.

487 17 C.F.R. §31.2 (1978).

488 17 C.F.R. §31.2 (1978).

489 43 Fed. Reg. 56,885, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,704, at p.22,859 (Dec. 5, 1978).

490 44 Fed. Reg. 6737, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,755, at pp. 23,093-23,098 (Feb. 2, 1979).

491 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,755, at p.23,094.

492 44 Fed. Reg. 13,494, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at pp. 23,157-23,170 (March 12, 1979).

493 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,772, at p.23,164.

494 44 Fed. Reg. 44,177, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,863, at p.23,538 (July 27, 1979). This determination was to be effective on January l, 1980, but was postponed by the Commission in December 1979. 44 Fed. Reg. 69,304, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,929, at p.23,748 (CFTC Dec. 10, 1979). In June 1980, the effective date of the determination was postponed until October 1, 1982, with interim regulations to be developed for the intervening period. CCH Newsletter No. 125, p.l (June 4, 1980).

495 112 Pub. L. 97-444, 96 Stat. 2322 (1983).

496 *See* H.R. Rep. 964, 97th Cong., 2d Cong., 2d Sess. (Dec. 13, 1982).

497 Pub. L. 97-444, 96 Stat. 2322 (1983). *See* 7 U.S.C. §23(d) (1982) (repealed 1983). The legislative history outlined above indicates that the CFTC was not necessarily ignoring a mandate from Congress to regulate LTMs but rather was examining carefully the difficult question—dodged by Congress itself—as to what a leverage contract is, how it can be distinguished from futures, and how best to regulate it. The CFTC's cautious action may have been vindicated by the 1986 moratorium on additional LTM registrations pending a two-year CFTC study. *See* Pub. L. 99-641, 100 Stat. 3560 (1986).

498 *See* Breyer v. First Nat'l Monetary Corp., 548 F. Supp. 955 (D.N.J. 1982) (decided prior to the effective date of the repeal of §19(d)).

499 *Id.* at 964-965. For the Commission's definition of leverage contract, *see* Reg. §31.4(w), 17 C.F.R. §31.4(w), CCH Rep. ¶ 2711 A:

> "Leverage contract" means a contract, standardized as to terms and conditions, for the long-term (ten years or longer) purchase ("long leverage contract") or sale ("short leverage contract") by a leverage customer of a leverage commodity which provides for:
>
> (1) Participation by the leverage transaction merchant as a principal in each leverage transaction;
>
> (2) Initial and maintenance margin payments by the leverage customer;
>
> (3) Periodic payment by the leverage customer or accrual by the leverage transaction merchant of a variable carrying charge or fee on the unpaid balance of a long leverage contract, and periodic payment or crediting by the leverage transaction merchant to the leverage customer of a variable carrying charge or fee on the initial value of the contract plus any margin deposits made by the leverage customer in connection with a short leverage contract;
>
> (4) Delivery of a commodity in an amount and form which can be readily purchased and sold in normal commercial or retail channels;
>
> (5) Delivery of the leverage commodity after satisfaction of the balance due on the contract; and
>
> (6) Determination of the contract purchase and repurchase, or sale and resale prices by the leverage transaction merchant.

See also the Commission's definition of leverage transaction in Reg. §31.4(x), 17 C.F.R. §31.4(x), CCH Rep. ¶ 2711A:

> "Leverage transaction" means the purchase or sale of any leverage contract, the repurchase or resale of any leverage contract, the delivery of the leverage commodity, or the liquidation or rescission of any such leverage contract by or to the leverage transaction merchant.

500 *See supra* §1.02[5].

501 17 C.F.R. §31.1 *et seq.*, CCH Rep. ¶¶ 2709 *et seq. See infra* §3.05[9].

502 *See infra* §1.06[1] - 1.06[9], 3.07 - 3.14.

503 Pub. L. 99-641, 100 Stat. 3560 (1986).

504 *See* H.R. Rep. 99-624, 99th Cong., 2d Sess. 13-14 (1986). *See also* Comment, The Future of Leverage Contract Trading under the Futures Trading Act of 1986, 37 Am. U.L. Rev. 157 (1987).

505 *See* H.R. Rep. 99-624, 99th Cong., 2d Sess. 13-14 (1986). *See* 7 U.S.C. §23(b), CCH Rep. ¶ 1451.

506 7 U.S.C. §23(b), CCH Rep. ¶ 1451.

507 *Id.* The CFTC rules are found in 17 C.F.R. §31.1 - 31.29, CCH Rep. ¶ 2709-2714H. *See infra* §3.05[9]. *See, e.g.*, CFTC v. P.I.E., Inc., 853 F.2d 721 (9th Cir. 1988) (purported leverage contracts having durations of less than ten years were futures contracts rather than a subset of leverage contracts that were left unregulated by the Commission; because these contracts were sold in off-exchange transactions, they violated the Act's contract market monopoly for futures contracts).

508 Performance of Functions Related to Leverage Transactions by National Futures Association, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,533 (Oct. 5, 1989).

509 *Id.* For the relevant rule changes, *see* Leverage Transactions, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,532 (Oct. 5, 1989).

510 *See also* NFA Rules Part 200.

511 7 U.S.C. §1a, CCH Rep. ¶ 1011. *See, e.g.*, CFTC v. Frankwell Bullion Ltd., 99 F.3d 299 (9th Cir. 1996), *aff'g* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,222 (N.D. Cal. 1994) (foreign currency transactions with daily rollover provisions until customer takes delivery or enters into an offset transaction could qualify as spot transactions). *Cf.* Clark, Production on Paper: Will Oil and Gas Futures and Spot Sales Supplant Posted and Regulated Prices?, 33 Rocky Mtn. Min. L. Inst. 20.1 (1988).

511.1 CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004).

511.2 *See*, *e.g.*, the CFTC's interpretation of "actual delivery" in the context of section 2(c)(2)(D) of the Act, which protects contracts resulting in actual delivery within 28 days from the applicability of the section, which effectively bars leveraged retail commodity transactions.

511.3 *See, e.g.*, CFTC v. Sterling Trading Group, Inc., 605 F. Supp. 2d 1245 (S.D. Fla. 2009) (denying summary judgment in suit claiming forex fraud); CFTC v. Int'l Foreign Currency, Inc., 334 F. Supp. 2d 305 (E.D.N.Y. 2005) (currency contracts were futures contracts not spot transactions); CFTC v. Int'l Fin. Servs. (New York), Inc., 323 F. Supp. 2d 482 (S.D.N.Y. 2004) (foreign currency transactions were not within statute's exemption and thus were within CFTC's jurisdiction).

512 *See, e.g.*, CFTC v. Zelener, 2003 WL 22284295 *4 (N.D. Ill. 2003) ; CFTC v. Frankwell Bullion Ltd, 1994 WL 449071 (N.D. Cal. 1994). The Zelener decision was affirmed. CFTC v. Zelener, 373 F.3d 861 (7th Cir. 2004) (rollovers of foreign currency sales were not “contracts of sale of a commodity for future delivery,” and dealer's promise did not create futures contract). CFTC v. Uforex Consulting, LLC, 551 F. Supp. 2d 513 (W.D. La. 2008) (rejecting CFTC's position and finding that foreign currency transactions were not futures contracts subject to CFTC jurisdiction). *See also, e.g.*, CFTC v. Erskine, 512 F.3d 309 (6th Cir. 2008) (foreign currency transactions were forward contracts rather than futures contracts as had been urged by the CFTC). *But cf.* CFTC v. Int'l Foreign Currency, Inc., 334 F. Supp. 2d 305 (E.D.N.Y. 2005) (currency contracts were futures contracts not spot transactions); CFTC v. Int'l Fin. Servs. (New York), Inc., 323 F. Supp. 2d 482 (S.D.N.Y. 2004) (foreign currency transactions were not within statute's exemption and thus were within CFTC's jurisdiction).

512.1 *See* United States v. Reliant Energy Servs., Inc., 420 F. Supp.2d 1043, 1061–1062 (N.D. Cal. 2006) (relying on this treatise); *In re* Natural Gas Commodity Litigation, 337 F. Supp.2d 498 (S.D.N.Y. 2004) (sufficient allegations of commodity manipulation designed to affect the futures market; plaintiffs were entitled to present evidence that wash trades in the spot market affected the futures markets and thus were actionable commodities manipulation).

512.2 CFTC v. Reed, 481 F. Supp. 2d 1190 (D. Colo. 2007) (denying motion to dismiss CFTC action for fraudulent reporting of natural gas transactions). *Cf.* CFTC v. NRG Energy, Inc., 457 F.3d 776 (8th Cir. 2006) (reinstating CFTC injunction against inaccurate reporting of natural gas prices). *See also, e.g.,* Geoffrey F. Aronow & Anthony M. Mansfield, Where Might CFTC Manipulation Jurisdiction End In OTC Trading?, 27 Futures & Deriv. L. Rep. 1 (No. 6. June 2007).

"Report" as used in section 9(a)(2) of the Act is not limited to official reports but rather applies to any reports containing information relating to matters that affect or tend to affect commodity pricing. United States v. Brooks, 681 F.3d 678, 691–692 (5th Cir. 2012) (upholding convictions for false reports relating to natural gas).

512.3 *See, e.g.,* CFTC v. Calvary Currencies, LLC, 437 F. Supp. 2d 453 (D. Md. 2006) (foreign currency transactions were futures transactions rather than spot transactions; defendant was a counterparty to a futures transaction and thus subject to CFTC jurisdiction in an action claiming defendant engaged in illegal off-exchange futures transactions). Because the CFTC's problem with over the counter forex contracts was the Commission's inability to persuade courts that these instruments were illegal futures contracts, one change in 2008 was to extend jurisdiction to retail forex instruments regardless of how they might be classified legally but only if they are offered or entered into on a leveraged, margined or financed basis or are delivered within two days. Thus, cash-and-carry sales of forex are not included within the CFTC's jurisdiction. The 2008 amendments to the Commodity Exchange Act clarified the Commission's jurisdiction with respect to over the counter (off-exchange) foreign currency contracts. As a result of the 2008 amendments to section 2(c)(2) of the Act, it is now clear that the CFTC has the authority to regulate over-the-counter foreign currency (forex) contracts that are offered to retail customers that do not qualify as eligible contract participants unless the counterparty is a financial institution, a securities broker-dealer registered under the Securities Exchange Act of 1934 (or associated person), or a registered retail foreign exchange dealer. Section 2(c)(2)(B), 7 U.S.C. § 2(c)(2)(B), CCH Rep. ¶ 1023.

513 In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC 1979).

514 *See, e.g.*, CFTC v. U.S. Metals Depository Corp., 468 F. Supp. 1149 (S.D.N.Y. 1979).

515 *See, e.g.*, In the Matter of Precious Metals Assocs., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,882 (CFTC 1979). *See also* CFTC v. Morgan, Hams & Scott, 484 F. Supp. 669 (S.D.N.Y. 1979).

516 *See* Office of General Counsel Interpretation No. 85-1, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,673 (CFTC August 6, 1985).

517 *See, e.g.*, Transnor (Bermuda) Ltd. v. BP North America Petroleum, 738 F. Supp. 1472 (S.D.N.Y. 1985).

518 *See* CFTC Statutory Interpretation Concerning Forward Transactions, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,865 (CFTC June 29, 1990).

519 *See* CFTC Exemption for Certain Contracts Involving Energy Products, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,633 (CFTC April 20, 1993).

519.1 *See* FINRA Reg. Notice 09-06, FINRA Requests Comment on Proposed Rule to Establish a Leverage Limitation for Retail Forex, available at https://www.finra.org/rules-guidance/notices/09-06 (FINRA Jan. 21, 2009).

519.2 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008).

519.3 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008).

519.4 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008).

519.5 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008).

519.6 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008). The net capital and customer protection rules are discussed in Jerry W. Markham & Thomas L. Hazen, Broker-Dealer Operations Under Securities and Commodities Law: Financial Responsibilities, Credit Regulation, and Customer Protection (2d ed. 2002).

519.7 *See* FINRA Reg. Notice 08-66, FINRA Addresses Firms' Retail Foreign Currency Exchange Activities, available at https://www.finra.org/rules-guidance/notices/08-66 (FINRA Nov. 2008).

519.8 *See, e.g.*, In the Matter of David Lee, Sec. Exch. Act Rel. No. 34-59107 (SEC Dec. 16, 2008) (settlement of administrative proceeding involving natural gas options trading).

519.9 Pub. Law No. 111-203, 124 Stat. 1376 (July 21, 2010), amending in part the Commodity Exchange Act, 7 U.S.C. § 1 *et seq*. This law is popularly known as the Dodd-Frank Act after its principal sponsors in the Senate and House of Representatives and will be referred to under that name in this discussion.

519.10 Amendments to the laws administered by the SEC are beyond the scope of this discussion. In general, swap agreements that relate to securities ("security-based swaps") now fall within the SEC's jurisdiction and are not regulated by the CFTC.

519.11 The Bank of International Settlements estimated that in 2009 the notional (face) value of all such instruments is approximately $600 trillion. *See* OTC Derivatives Market Activity in the First Half of 2009, available at http://www.bis.org/publ/otc_hy0911.pdf (Nov. 2009).

519.12 As discussed later, "credit default swaps" are actually a species of financial instrument different from "swaps" generally.

519.13 Section 1a(47)(A), 7 U.S.C. § 1a(47), CCH Rep. ¶ 1002, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(21), Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010).

519.14 *See* Securities Exchange Act § 3(a)(68), 15 U.S.C. § 78c(a)(68).

519.15 Section 1a(47), 7 U.S.C. § 1a(47), CCH Rep. ¶ 1002.

519.16 The referenced benchmark may be just about anything, tangible or intangible, and the word "thing" is used here as a reminder.

519.17 Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208-48366 (CFTC/SEC Aug. 13, 2012).

519.18 Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694-69705 (Department of the Treasury Nov. 20, 2012).

519.19 Section 1a(47)(B), 7 U.S.C. §1a(47)(B), CCH Rep. ¶1002, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act §721(a)(21), Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010). As explained by a CFTC official, the definition of swap "includes not only traditional swaps, including agriculture swaps and commodity swaps but also options of any kind—any kind of OTC option is now a swap and is going to be covered by whatever rules the commission does for swaps." *See* CFTC Faces "Major Issue" on "Special Conditions" for Ag Swaps, 42 Sec. Reg. & L. Rep. (BNA), 1519, available at https://news.bloomberglaw.com/securities-law/cftc-faces-major-issue-on-special-conditions-for-ag-swaps (sub. req.) (Aug. 6, 2010). The CFTC adopted a regulation to provide that swaps on agricultural commodities will trade subject to the same rules and provisions applicable to other swaps. *See* 17 C.F.R. Part 35, adopted in Agricultural Swaps, 76 Fed. Reg. 49291-01, 2011 WL 3468762 (CFTC Aug. 10, 2011).

519.20 Section 1a(47)(B), 7 U.S.C. § 1a(47)(B), CCH Rep. ¶ 1002, as added by Dodd-Frank Wall Street Reform and Consumer Protection Act § 721(a)(21), Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010).

519.21 *See* § 1.02[8][B] *supra*. Based on existing CFTC policy with respect to forward contracts, this exclusion from the definition of swap will apply to what are essentially forward contracts where the parties agree to settle the contract without delivery through payment of the price difference. As explained by a CFTC official, forward contracts continue to be excluded from CFTC jurisdiction and can "continue as before, with no change." *See* CFTC Faces "Major Issue" on "Special Conditions" for Ag Swaps, 42

Sec. Reg. & L. Rep. (BNA), 1519, available at http://news.bna.com/srln/SRLNWB/split_display.adp?fedfid=17601013&vname=srlrnotallissues&fn=17601013&jd=a0c3x6a3n5&split=0 (Aug. 9, 2010).

519.22 Section 1a(47)(B), 7 U.S.C. § 1a(47)(B).

519.23 Section 5b, 7 U.S.C. § 7a-1, CCH Rep. ¶ 1213; Dodd-Frank Wall Street Reform and Consumer Protection Act § 723, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010).

519.24 The Commission is given the authority, but is not required, to promulgate rules defining what is meant by "commercial risk." Also, The Dodd-Frank Act creates a new criminal offense for any person to "abuse" the clearing exemption for end users. Section 9(a)(6), 7 U.S.C. § 13(a)(6), CCH Rep. ¶ 1341. The CFTC is to determine what acts or practices constitute this offense but, presumably, claiming exemption based on false data or with knowledge that one is disqualified may fall within those parameters.

519.25 A public company that wishes to rely on the end user exemption also will be required to obtain the approval of its board of directors or governing body. Dodd-Frank Wall Street Reform and Consumer Protection Act § 723, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010), amending section 2, 7 U.S.C. § 2, CCH Rep. ¶¶ 1011–1030.

519.26 End-User Exception to the Clearing Requirement for Swaps, 77 Fed. Reg. 42560, 2012 WL 2920653 (CFTC July 19, 2012).

519.27 Reg. § 39.6, 17 C.F.R. § 39.6, CCH Rep. ¶ 2855.

519.28 The Act defines a small financial institution as one with less than $10 billion in total assets. Section 2(h)(7)(C)(ii), 7 U.S.C. § 2(h)(7)(C)(ii), CCH Rep. ¶ 1028.

519.29 *See* CFTC Press Rel. No. 6328-12, CFTC Proposes Inter-Affiliate Clearing Exemption, available at http://cftc.gov/PressRoom/PressReleases/6328-12 (CFTC Aug. 16, 2012).

519.30 Language to this effect in the Senate version of the legislation was omitted from the Act as after the House-Senate Conference. There is helpful legislative history expressly addressing this issue, but the outcome will be uncertain until definitively addressed in a technical corrections bill or by Commission rulemaking.

519.31 Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant" "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 Fed. Reg. 30596–30763 (CFTC/SEC May 23, 2012). *See* § 1.12B.

519.32 *See* Large Trader Reports for Physical Commodity Swaps, 76 Fed. Reg. 43851-01, 2011 WL 2911756 (CFTC July 22, 2011). The new regulations currently cover 46 physical commodities and also "[f] or the purpose of reporting in futures equivalents, paired swaps and swaptions using commodity reference prices that are commonly known diversified indices with publicly available weightings may be reported as if such indices underlie a single futures contract with monthly expirations for each calendar month and year." *Id.* note 12.

519.33 *See* Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44464-01, 2011 WL 3020467 (CFTC July 26, 2011).

519.34 Dodd-Frank Wall Street Reform & Consumer Protection Act § 737, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010), amending section 4a(a), 7 U.S.C. § 6a(a), CCH Rep. ¶ 1041.

519.34a CFTC Proposed Rule, Position Limits for Derivatives, 78 Fed. Reg. 75680 (Dec. 12, 2013).

519.35 International Swaps & Derivatives Ass'n v. U.S. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012).

519.36 Investment Co. Inst. v. CFTC, 720 F.3d 370 (D.C. Cir. 2013). In rejecting the plaintiffs' claims, the court of appeals stated that an agency is not required to address previous rationales when, in a new rulemaking, the agency "changes course," and therefore the CFTC was not required to address its rationale for broadening the relevant exemptions in 2003. With respect to the plaintiffs' cost-benefit argument, the court of appeals drew a distinction between this case and two recent cases in which the court of appeals had vacated SEC rules. Unlike the SEC in the prior cases, the CFTC considered whether registered investment companies were otherwise regulated, and concluded that CFTC regulation was nonetheless necessary. The court of appeals upheld the CFTC's multi-step rulemaking process under which rules will need to be later harmonized with SEC rules, although it noted that the plaintiffs may challenge the costs and benefits of the harmonization rulemaking one such rules are finalized.

519.37 Bloomberg LP v. U.S. CFTC, 2013 WL 2458283 (D.D.C. June 7, 2013).

519.38 Sec. Exch. Act §3(a)(71), 15 U.S.C.A. §78c(a)(71) as added by Dodd-Frank Wall Street Reform and Consumer Protection Act §761, Pub. Law 111-203, H.R. 4173 (111th Cong. 2d sess. 2010). *Compare* Section 1a(49), 7 U.S.C. §1a(49), CCH Rep. ¶1002.

519.39 Further Definition of “Swap Dealer,” “Security-Based Dealer,” “Major Swap Participant” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596–30763 (CFTC/SEC May 23, 2012).

519.40 Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208–48366 (CFTC/SEC Aug. 13, 2012).

519.41 These include, among others: (i) spot transactions, including cash market transactions in foreign exchange, commodities and securities; (ii) futures and options on futures; (iii) options on a single security or group or index of securities; and (iv) physically settled forward transactions, including transactions in commodities and securities for deferred delivery. *Id.*

519.42 A “foreign exchange forward” is a transaction that solely involves the exchange of two different currencies on a specific future date at a fixed rate agreed upon on the inception of the contract covering the exchange. Section 1a(24), 7 U.S.C. §1a(24).

519.43 A “foreign exchange swap” is a transaction that solely involves: (i) an exchange of two different currencies on a specific date at a fixed rate that is agreed upon on the inception of the contract covering the exchange; and (ii) a reverse exchange of those two currencies at a later date and at a fixed rate that is agreed upon on the inception of the contract governing the exchange. Section 1a(25), 7 U.S.C. §1a(25).

519.44 Determination of Foreign Exchange Swaps and Foreign Exchange Forwards Under the Commodity Exchange Act, 77 Fed. Reg. 69694–69705 (Department of the Treasury Nov. 20, 2012).

519.45 “Spot foreign exchange” transactions is defined as physical foreign exchange transactions that settle within T + 2 or within another timeline typical of the particular market, or settle contemporaneously with a securities transactions. *See* Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement”; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48208–48366 (CFTC/SEC Aug. 13, 2012).

519.46 *See* §§1.06 – 1.12 *infra*. Certain other categories of registration such as “leverage contract merchants” and “agricultural trade option merchants” have fallen into disuse or no longer exist.

519.47 *See, e.g.*, Commodity Exchange Act §§1a(11), 1a(12), 1a(22), 1a(23), 1a(28), 1a(31), 7 U.S.C. §1a, CCH Rep. ¶1002.

519.48 For example, a person currently registered as a “floor trader” and who makes markets by trading for that person's own account might be required, for swap transactions, to register anew as a “swap dealer” because the latter's definition is very similar. Compare Commodity Exchange Act §1a(23) (floor trader) with §1a(49) (swap dealer), 7 U.S.C. §1a, CCH Rep. ¶1002.

519.49 The discussion of swap dealer registration procedures is paired here with the registration of a “major swap participant” because the requirements are virtually identical. First, however, the new registration categories are defined. On April 28, 2012, the CFTC adopted its regulations addressing the definition of swap dealer and major swap participant. *See* Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596, 30606 (May 23, 2012). These definitions are discussed in §1.12B *infra*.

When it adopted the new regulation, the Commission estimated that approximately 125 entities will fall within the “swap dealer” and “major swap participant” definitions. Out of those entities, only six or fewer are expected to fall within the “major swap participant” definition.

519.50 Section 1a(50), 7 U.S.C. §1a, CCH Rep. ¶1002. As stated at note 519.77, *infra*, this description could also describe the traditional registered floor trader (and, by virtue of CFTC Regulation §3.4(a), 17 C.F.R. §3.4(a), a registered floor broker) and it is unclear whether, in relation to its own swap trading, a second registration as a swap dealer will be required.

519.51 Sections 1a(23) and 4e, 7 U.S.C. §§1a and 6e, CCH Rep. ¶¶1002, 1081. A significant motivation for registering floor traders was their critical role as liquidity providers on the physical trading floors of the exchanges at that time and where they could—and sometimes did—use the advantage of proximity to engage in unlawful and abusive practices.

519.52 Pub. Law No. 102-546, 106 Stat. 3590, 3604 (Oct. 28, 1992).

519.53 CFTC Regulations §§15.00 *et seq.*, 17 C.F.R. §§15.00 *et seq.*, CCH Rep. ¶¶2536–2542.

519.54 CFTC Regulations §§21.00 *et seq.*, 17 C.F.R. §§21.00 *et seq.*, CCH Rep. ¶¶2580–2584.

519.55 *See, e.g.*, CFTC Regulations §§150.1 *et seq.*, CCH Rep. ¶¶3131–3136.

519.55a De Minimis Exception to the Swap Dealer Definition, 83 Fed. Reg. 56666 (Nov. 13, 2018). *See* discussion at §1.12B, *infra*.

519.56 Sections 1a(33) and 4s, 7 U.S.C. §§1a(33) and 6s.

519.57 Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant” “Major Security-Based Swap Participant” and “Eligible Contract Participant,” 77 Fed. Reg. 30596–30763 (CFTC/SEC May 23, 2012). *See* §1.12B.

519.58 An SEF is defined at Section 1a(50), 7 U.S.C., §1a(50), and the registration requirements are found at Section 4s, 7 U.S.C. §6s, CCH Rep. ¶¶1002, 1195.

519.59 Note, however, that an SEF may not offer swaps on any agricultural commodity until such time as the CFTC authorizes it. Section 5h(b)(2), 7 U.S.C. §7b-2, CCH Rep. ¶1240. The term “agricultural commodity” is not defined in the Act, creating the possibility that it may be construed to include farm products beyond those specifically listed in the definition of “commodity” under Section 1a(9), 7 U.S.C. §1a, such as vegetables, fruits, seasonings etc. In July 2011, the Commission adopted a definition of agricultural commodity that basically tracks the language of the statute defining agricultural commodity as including “[w]heat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions” Reg. §1.3(zz)(1), 17 C.F.R. §1.3(zz)(1), CCH Rep. ¶2128. The CFTC definition then includes “[a]ll other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber” (17 C.F.R. §1.3(zz)(2), CCH Rep. ¶2128) as well as “[t]obacco, products of horticulture, and such other commodities used or consumed by animals or humans as the Commission may by rule, regulation or order designate after notice and opportunity for hearing.” 17 C.F.R. §1.3(zz)(3), CCH Rep. ¶2128. *See* Agricultural Commodity Definition, 76 Fed. Reg. 41048, 2011 WL 2689275 (CFTC July 13, 2011). The definition also includes “[c]ommodity-based indexes based wholly or principally on underlying agricultural commodities.” 17 C.F.R. §1.3(zz)(4). The CFTC also adopted a rule providing that swaps on agricultural commodities will trade subject to the same rules and provisions applicable to other swaps. *See* 17 C.F.R. Part 35, adopted in Agricultural Swaps, 76 Fed. Reg. 49291, 2011 WL 3468762 (CFTC Aug. 10, 2011).

Note, as well, that Section 5, 7 U.S.C. §7, CCH Rep. ¶¶1201–1205, provides that futures contracts on any of the agricultural commodities enumerated in Section 1a(9), 7 U.S.C. §1a, and already trading on a designated contract market as of the Dodd-Frank Act's enactment “may be traded *only* on a contract market designated under this section [5] (emphasis added).” This language suggests that the CFTC may be constrained in what agricultural futures it may authorize an SEF to trade.

Moreover, the Act allows the CFTC and the SEC to delimit what swaps may be offered by an SEF, bearing in mind that maximum use of SEFs is the goal. Section 5h(d), 7 U.S.C. §7b-2, CCH Rep. ¶1240.

519.60 Section 5h(c), 7 U.S.C. §7b-2, CCH Rep. ¶1240. Registration is not waived even if the facility has registered with the SEC as an SEF for purposes of trading security-based swaps. *See* Section 5h(a)(2), 7 U.S.C. §7b-2, CCH Rep. ¶1240.

519.61 Indeed, the showings required for SEF registration are quite similar to those for a designated contract market and may cause some interested trading systems to elect the latter status in order to offer the broader panoply of CFTC products available there.

519.62 The quoted phrase suggests that SEFs will not be compelled in all instances to impose speculative position limits but the exceptions are not known at this time. Section 5h((f)(6), 7 U.S.C. §7b-2) **,** CCH Rep. ¶1240.

519.63 Section 5h(f), 7 U.S.C. §7b-2, CCH Rep. ¶1240, allows the CFTC to set data collection and reporting requirements for SEFs that are similar to those for derivatives clearing organizations and swap data repositories (discussed below).

519.64 While the core principles for SEFs are comparable to those Section 5, 7 U.S.C. §7, CCH Rep. ¶¶1201 *et seq.*, imposes on designated contract markets, there are omissions such as no explicit duty to offer an alternative dispute resolution mechanism or to consider views of market participants in its decisions or to operate a formal disciplinary system (although detection of abuses is required).

519.65 Core Principles and Other Requirements for Swap Execution Facilities, 78 Fed. Reg. 33476–33604 (CFTC June 4, 2013). *See* §2.02[7][C][vi] *infra*.

519.65a Swap Execution Facilities and Trade Execution Requirement, 83 Fed. Reg. 61946 (Nov. 30, 2018). *See* additional discussion of this rule proposal in §2.02[7][C][vi] *infra*.

519.65b *Id.* at 62144.

519.65c Post-Trade Name Give-Up on Swap Execution Facilities, 83 Fed. Reg. 61571 (Nov. 30, 2018).

519.65d Swap Execution Facilities and Trade Execution Requirement, 84 Fed. Reg. 3350 (Feb. 12, 2019); Post-Trade Name Give-Up on Swap Execution Facilities, 84 Fed. Reg. 3350 (Feb. 12, 2019).

519.66 Sections 1a(48) and 21, 7 U.S.C. §§1a(48), 24, CCH Rep. ¶¶1002, 1471. The fact that the entity may also be registered as a swap data repository with the SEC for security-based swaps does not satisfy the obligation to register with the CFTC as well. Section 21(g), 7 U.S.C. §24a(g), CCH Rep. ¶1471.

519.67 Section 5(d)(8), 7 U.S.C. §7(d)(8), CCH Rep. ¶1204G.

519.68 Section 5b(c)(2)(L), 7 U.S.C. §7a-1(c)(2)(L), CCH Rep. ¶1216K.

519.69 Section 5h(f)(9), 7 U.S.C. §7b-2, CCH Rep. ¶1240.

519.70 *See* section 2(a)(13)(C), 7 U.S.C. §2(a)(13)(C), CCH Rep. ¶1021A (clearing organization cannot be forced to accept a swap) and Section 2(h)(8), 7 U.S.C. §2h(8), CCH Rep. ¶1028 (refusal by designated contract market or swap execution facility).

519.71 Section 2(h)(7), 7 U.S.C. §2(h)(7), CCH Rep. ¶1028.

519.72 *See* §§1.06 – 1.12 *infra*. Certain other categories of registration such as “leverage contract merchants” and “agricultural trade option merchants” have fallen into disuse or no longer exist.

519.73 Section 1a(3), 7 U.S.C. §1a(3), CCH Rep. ¶1002.

519.74 Section 4s(b)(6), 7 U.S.C. §6s(b)(6), CCH Rep. ¶1195.

519.75 Section 8a, 7 U.S.C. §12a, CCH Rep. ¶1301.

519.76 Section 4a(a)(4), 7 U.S.C. §6a(a)(4), CCH Rep. ¶1041, identifies the criteria to be used by the CFTC in determining whether a contract has significant price discovery features, such as whether the swap relies on prices emanating from a regulated market, whether a sufficient price relationship exists with a regulated contract to permit arbitrage between them, whether swap prices are used for regulated transactions, and other considerations.

519.77 Section 1a(40), 7 U.S.C. §1a(40), CCH Rep. ¶1002.

519.78 Section 4a(6), 7 U.S.C. §6a(6), CCH Rep. ¶1041.

519.79 Section 1a(28), 7 U.S.C. §1a(28), CCH Rep. ¶1002. *See* §1.06 *infra*.

519.80 Section 1a(31), 7 U.S.C. §1a(31), CCH Rep. ¶1002. *See* §1.08 *infra*.

519.81 Section 1a(11), 7 U.S.C. §1a(11), CCH Rep. ¶1002. *See* §1.11 *infra*.

519.82 Section 1a(12), 7 U.S.C. §1a(a)(12), CCH Rep. ¶1002. *See* §1.10 *infra*.

519.83 Section 1a(22), 7 U.S.C. §1a(22), CCH Rep. ¶1002. *See* §1.09 *infra*.

519.84 Section 1a(23), 7 U.S.C. §1a(23), CCH Rep. ¶1002. *See* §1.11 *infra*.

519.85 Section 5h(a)(1), 7 U.S.C. §7b-2, CCH Rep. ¶1240: “No person may operate a facility for the trading or processing of *swaps* unless the facility is registered as a swap execution facility or as a *designated contract market* under this section. “(emphasis added).

519.86 Section 5b(a)(1), 7 U.S.C. §7a-1(a)(1), CCH Rep. ¶1213.

519.87 Section 1a(9), 7 U.S.C. §1a(9), CCH Rep. ¶1002 and a corresponding amendment to Pub. Law No. 85-839, 7 U.S.C. §13-1. Query whether the phrase “board of trade” includes a swap execution facility but the definition would appear broad enough to do so. Section 1a(6), 7 U.S.C. §1a(6), CCH Rep. ¶1002.

519.88 Section 1a(19), 7 U.S.C. §1a(19), CCH Rep. ¶1002. The term “excluded commodity” includes most financial instruments, a wide variety of indices and other measurements, and contingencies beyond the parties' control that have economic consequences.

519.89 *But see* Philip McBride Johnson, *In Defense of “Terrorist” Derivatives*, 23 Futures & Deriv. L. Rep. 26 (No. 5, July/August 2003).

519.90 Section 5c(c)(5)(C), 7 U.S.C. §7a-2(c)(5)(C), CCH Rep. ¶1223. For example, in April 2012, the Commission explained: “as a result of reviewing the complete record, the CFTC determined that the contracts involve gaming and are contrary to the public interest, and cannot be listed or made available for clearing or trading.” CFTC Press Rel. No. 6224-12, CFTC Issues Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts, available at http://www.cftc.gov/PressRoom/PressReleases/6224-12 (CFTC Apr. 2, 2012).

519.91 CFTC Press Rel. No. 6224-12, CFTC Issues Order Prohibiting North American Derivatives Exchange's Political Event Derivatives Contracts, available at http://www.cftc.gov/PressRoom/PressReleases/6224-12 (CFTC Apr. 2, 2012).

519.92 Section 4a, 7 U.S.C. §6a, CCH Rep. ¶¶1041 *et seq.*, and CFTC Regulations §§150.1–150.4, 17 C.F.R. §§150.1–150.4, CCH Rep. ¶¶3131–3134.

519.93 Section 4a(e), 7 U.S.C. §6a(e), CCH Rep. ¶1045, and CFTC Regulations §§150.5–150.6, 17 C.F.R. §§150.5–150.6, CCH Rep. ¶¶3135–3136.

519.94 *See* Section 1a(19), 7 U.S.C. §1a(19), CCH Rep. ¶1002. The term “excluded commodity” includes most financial instruments, a wide variety of indices and other measurements, and contingencies beyond the parties' control that have economic consequences.

519.95 Section 1a(20), 7 U.S.C. §1a(20), CCH Rep. ¶1002: The term “exempt commodity” includes virtually all commodities that are tangible, such as energy and metals.

519.96 The term “agricultural commodity” is not defined in the Act. While the phrase might be viewed as applicable only to the specific farm products identified in the definition of “commodity” under Section 1a(9), 7 U.S.C. §1a(9), CCH Rep. ¶1002 CFTC staff have indicated informally that the term may be applied more broadly to include anything with an agricultural source. In July 2011, the Commission adopted a definition of agricultural commodity that basically tracks the language of the statute by defining agricultural commodity:

(zz) Agricultural commodity. This term means:

1) The following commodities specifically enumerated in the definition of a "commodity" found in section 1a of the Act: Wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions;
2) All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber;
3) Tobacco, products of horticulture, and such other commodities used or consumed by animals or humans as the Commission may by rule, regulation or order designate after notice and opportunity for hearing; and
4) Commodity-based indexes based wholly or principally on underlying agricultural commodities.

Reg. §1.3(zz), 17 C.F.R. §1.3(zz), CCH Rep. ¶2128. *See* Agricultural Commodity Definition, 76 Fed. Reg. 41048-01, 2011 WL 2689275 (CFTC July 13, 2011). The CFTC also adopted a rule providing that swaps on agricultural commodities will trade subject to the same rules and provisions applicable to other swaps. *See* 17 C.F.R. Part 35, adopted in Agricultural Swaps, 76 Fed. Reg. 49291-01, 2011 WL 3468762 (CFTC Aug. 10, 2011).

519.97 Section 4a(a)(3), 7 U.S.C. §6a(a)(3), CCH Rep. ¶1041. The International Swaps and Derivatives Association(ISDA) and the Securities Industry and Financial Markets Association(SIFMA) brought suit challenging the Commission's position limits rulemaking under the Dodd-Frank Act. ISDA v. CFTC, No. 1:11-CV-2146 (D.D.C. filed Dec. 2, 2011). The challengers claim among other things that the Commission did not engage in a sufficient cost-benefit analysis. The D.C. District Court vacated and remanded the position limits rule. ISDA v. U.S. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012). The CFTC proposed a new position limits rule in November 2013. Proposed Rule on Position Limits for Derivatives, available at https://www.cftc.gov/LawRegulation/FederalRegister/ProposedRules/2013-27200.html (CFTC Nov. 2013).

519.98 Sections 4a(a)(4) and (6), 7 U.S.C. §6a(a)(4) and (6), CCH Rep. ¶1041.

519.99 Section 4a(a)(5), 7 U.S.C. §6a(a)(5), CCH Rep. ¶1041.

519.100 Position Limits for Futures and Swaps, 76 Fed. Reg. 71626-01, 2011 WL 5593018 (CFTC Nov. 18, 2011).

519.101 *Id.*

519.102 Section 5(d)(5), 7 U.S.C. §7(d)(5), CCH Rep. ¶1204D. This requirement is modified by the phrase "as is necessary and appropriate."

519.103 Section 5h(f)(6), 7 U.S.C. §7b-2, CCH Rep. ¶1240. This requirement is modified by the phrase "as is necessary and appropriate."

519.104 *See* note 519.123 (excluded commodity), *infra*.

519.105 Section 5(d)(5)(B), 7 U.S.C. §7(d)(5)(B), CCH Rep. ¶1204D and Section 5h(f)(6), 7 U.S.C. §7b-2, CCH Rep. ¶1240.

519.106 Section 4a(c), 7 U.S.C. §6a(c), CCH Rep. ¶ 1043 and CFTC Reg. §1.3(z), 17 C.F.R. §1.3(z), CCH Rep. ¶ 2128.

519.107 Section 4a(a)(6), 7 U.S.C. §6a(a)(6).

519.108 *See* Section 4a(c), 7 U.S.C. §6a(c), CCH Rep. ¶1043 and CFTC Regulation §1.3(z), 17 C.F.R. §1.3(z), CCH ¶2128.

519.109 CFTC Regulation §1.3(z)(3), 17 C.F.R. §1.3(z)(3), CCH Rep. ¶2128 and CFTC Regulation §1.47, 17 C.F.R. §1.47, CCH Rep. ¶2182A.

519.110 International Swaps & Derivatives Ass'n v. U.S. CFTC, 887 F. Supp. 2d 259 (D.D.C. 2012).

519.111 Proposed Rule on Position Limits for Derivatives, available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110513c.pdf (CFTC Nov. 2013).

519.111a Position Limits for Derivatives, 81 Fed. Reg. 96704 (Dec. 30, 2016).

519.111b Position Limits for Derivatives, 85 Fed. Reg. 11596 (Feb. 27, 2020).

519.111c Aggregation of Positions, 81 Fed. Reg. 91454 (CFTC, Dec. 16, 2016). On May 2, 2018, CFTC staff issued interpretive guidance providing that when an institutional investor qualifies for the Rule 150.4(b)(1) exemption from position aggregation with respect to its investment in a fund that is a commodity pool, the institutional investor is not required to look through its investment in a fund to aggregate commodity interest positions of an underlying portfolio company in which the institutional investor may hold a 10 percent or greater indirect interest (via its investment in the fund). CFTC Letter No. 18-12, Request for Interpretation Regarding Commission Regulation 150.4(b)(1).

519.111d In the Matter of Glencore Agric. B.V., f/k/a Glencore Grain B.V., & Glencore Ltd., CFTC Docket No. 18-12 (Apr. 30, 2018).

519.111e In the Matter of McVean Trading & Invs., LLC, CFTC No. 17-15 (June 21, 2017).

519.112 Section 2(h)(8)(B), 7 U.S.C. §2(h)(8)(B), CCH Rep. ¶1028. *See* James M. Cain, Warren N. Davis, Ann M. Battle, Doyle R. Campbell & Raymond A. Ramirez, Dodd-Frank Necessitates New Legal Documentation for Cleared Swaps, 44 Rev. Sec. & Commod. Reg. 155 (No. 13, July 13, 2011).

519.113 Section 2(h), 7 U.S.C. §2(h), CCH Rep. ¶1028.

519.114 Section 2(h)(2), 7 U.S.C. §2(h)(2), CCH Rep. ¶1028. In July 2011, the CFTC established the process for reviewing mandatory clearing. *See* Process for Review of Swaps for Mandatory Clearing, 76 Fed. Reg. 44464-01, 2011 WL 3020467 (CFTC July 26, 2011).

519.115 Section 2(h)(4)(C), 7 U.S.C. §2(h)(4)(C), CCH Rep. ¶1028.

519.116 Section 2(h)(4), 7 U.S.C. §2(h)(4), CCH Rep. ¶1028.

519.117 Section 4r, 7 U.S.C. §6r, CCH Rep. ¶1194. Generally, the reporting duty devolves onto a swap dealer or a major swap participant if it is a party to the trade.

519.118 Section 2(h)(7)(E), 7 U.S.C. §2(h)(7)(E), CCH Rep. ¶1028.

519.119 Section 4d(f)(2), 7 U.S.C. §6d(f)(2), CCH Rep. ¶1071.

519.120 Section 4d(f)(5), 7 U.S.C. §6d(f)(5), CCH Rep. ¶1071.

519.121 Section 2(h)(7)(C), 7 U.S.C. §2(h)(7)(C), CCH Rep. ¶1028. The term "financial entity" means a swap dealer, a major swap participant, a commodity pool, certain private funds and pension plans, and banking organizations.

519.122 Section 2(h)(7)(A), 7 U.S.C. §2(h)(7)(A), CCH Rep. ¶1028. It is unclear whether the CFTC is authorized to refuse the clearing exemption if it finds the party's explanation of financial preparedness to be unsatisfactory.

519.123 Section 2(j), 7 U.S.C. §2(j) CCH Rep. ¶1030.

519.124 Section 4s(l), 7 U.S.C. §§1 *et seq.*

519.125 Swap Transaction Compliance and Implementation Schedule: Clearing Requirement Under Section 2(h) of the CEA, 77 Fed. Reg. 44441–44456 (CFTC July 30, 2012).

519.126 An "active fund" is defined as any private fund under section 202(a) of the Investment Advisors Act of 1940 that is not a third-party subaccount and which executes 200 or more swaps per month on average over the course of the 12 months preceding a final clearing determination by the CFTC. *See* 17 C.F.R. §50.25.

519.127 The rule defines a third-party subaccount as a managed account where the manager is unaffiliated with the account's beneficial owner and is responsible for the documentation necessary for the account's beneficial owner to clear swaps. *Id.*

519.128 Clearing Requirement Determination Under Section 2(h) of the CEA, 77 Fed. Reg. 74283–74339 (CFTC Dec. 13, 2012). The CDS designated for mandatory clearing include specified tenors of recent series of the untranched CDX North American Investment Grade and High Yield indices and the untranched iTraxx Europe, iTraxx Europe Crossover and iTraxx Europe HiVol indices. The IRS designated for mandatory clearing include specified tenors of fixed-to-floating, floating-to-floating, forward rate agreement and overnight indexed swaps denominated in U.S. dollars, Euros, British pounds and (other than for overnight indexed swaps) Japanese yen.

519.128a Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps, 81 Fed. Reg. 71202 (CFTC Oct. 14, 2016).

519.129 Clearing Exemption for Swaps Between Certain Affiliated Entities, 78 Fed. Reg. 21749–21785 (CFTC Apr. 11, 2013) (codified at 17 C.F.R. §50.52). *See also* §§1.12A, 3.11[9], and 3.13[24] *infra.*

519.130 Staff No-Action Relief: For Swaps Between Affiliated Counterparties That Are Neither Swap Dealers Nor Major Swap Participants from Certain Swap Data Reporting Requirements Under Parts 45, 46, and Regulation 50.50(b) of the Commission's Regulations (CFTC No-Action Letter No. 13-09, Apr. 5, 2013).

519.130a *See* No-Action Relief from the Commodity Exchange Act Section 2(h)(8) for Swaps Executed Between Certain Affiliated Entities Not Electing Commission Regulation §50.52 (CFTC No-Action Letter No. 14-26, Mar. 6, 2014).

519.130b *See* Extension of Time-Limited No-Action Relief from Commodity Exchange Act Section 2(h)(8) for Swaps Executed Between Certain Affiliated Entities that are Not Exempt from Clearing Under Commission Regulation §50.52 (CFTC No-Action Letter No. 14-136, Nov. 7, 2014).

519.130c Extension of Time-Limited No-Action Relief from Commodity Exchange Act Section 2(h)(8) for Swaps Executed Between Certain Affiliated Entities that Are Not Exempt from Clearing Under Commission Regulation 50.52 (CFTC No-Action Letter No. 16-80, Nov. 28, 2016).

519.131 *See* Confirmation, Portfolio Reconciliation, Portfolio Compression, and Swap Trading Relationship Documentation Requirements for Swap Dealers and Major Swap Participants, 77 Fed. Reg. 55904–55966 (CFTC Sept. 11, 2012); *See also* §1.12B *infra*.

519.132 *See* §3.11[9] *infra.*

519.133 *See* §3.13[24] *infra.*

519.133a *See* 78 Fed. Reg. 21763–21766 (Apr. 11, 2013).

519.133b Exemption from the Swap Clearing Requirement for Certain Affiliated Entities—Alternative Compliance Frameworks for Anti-Evasionary Measures, 85 Fed. Reg. 44170 (July 22, 2020).

519.134 Clearing Exemption for Certain Swaps Entered Into by Cooperatives, 78 Fed. Reg. 52286 (CFTC Aug. 22, 2013).

519.135 Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21277–21310 (CFTC Apr. 9, 2012).

519.136 These requirements apply not only to swaps, but also futures, security futures commodity options and other enumerated agreements. *See* 17 C.F.R. §23.609.

519.137 *See* Customer Clearing Documentation, Timing of Acceptance for Clearing, and Clearing Member Risk Management, 77 Fed. Reg. 21277–21310 (CFTC Apr. 9, 2012).

519.138 No-Action Relief from the Clearing Requirement for Swaps Entered into by Eligible Treasury Affiliates (CFTC No-Action Letter No. 13-22, Oct. 11, 2012).

519.139 Section 2(c)(2)(D), 7 U.S.C. §2(c)(2)(D), as amended by Dodd-Frank Wall Street Reform and Consumer Protection Act §742, Pub. Law No. 111-203, H.R. 4173 (111th Cong. 2d sess. 2010).

519.140 Section 2(c)(2)(E), 7 U.S.C. §2(c)(2)(E).

519.141 Section 2(c)(2)(D).

519.142 Retail Commodity Transactions Under Commodity Exchange Act, 78 Fed. Reg. 52426 (CFTC Aug. 23, 2013).

519.143 *Id* at 52428.

519.144 749 F.3d 967 (1lth Cir. 2014).

519.145 *Id.* at 977.

519.146 *Id.* at 978–979, *citing Black's Law Dictionary* 494 (9th ed. 2009).

519.147 *Id.*

519.148 *Id.*

519.149 *Id.* at 980.

519.150 2014 WL 11350233 (S.D. Fla. Oct. 27, 2014) (slip copy).

519.151 *Id*. at *2.

519.152 *Id.*

519.153 *Id.* at *2–3.

519.154 2016 WL 3082645 (7th Cir. June 1, 2016).

519.155 *Id.* at *2–3 ("Throughout this litigation, the Commission has relied on *U.S. CFTC v. Hunter Wise Commodities, LLC*, 749 F.3d 967 (11th Cir. 2014), which held that a retail metals dealer that implemented a program considerably different from Atlas (Hunter Wise did not carry *any* inventory of metals) was within the scope of §2(c)(2)(D)(i) and not excluded by §2(c)(2)(D)(ii)(III)(aa). Monex believes that the Commission misunderstands *Hunter Wise* and that the Eleventh Circuit's decision favors its position.").

519.156 *Id.* at *2.

519.156a CFTC v. Monex Credit Co., 311 F. Supp. 3d 1173 (C.D. Cal. 2018), *rev'd*, 931 F.3d 966 (9th Cir. 2019), *cert. denied sub nom.* Monex Deposit Co. v. CFTC, 2020 WL 3492657 (June 29, 2020).

519.156b The court opined, however, that the actual delivery exemption did not bar application of Section 6(c)(1) and CFTC Rule 180.1, but dismissed those claims on grounds that those provisions applied only to fraud that manipulated market prices and the complaint did not allege price manipulation. *See* discussion at §5.05[3].

519.156c CFTC v. Monex Credit Co., 311 F. Supp. 3d at 1181–1183.

519.156d *Id.*

519.156e *Id.* at 1181.

519.156f *Id*. at 1182, *quoting* H.R. 4173, 100th Cong., 2nd Sess. §742(2)(D)(v) (May 20, 2010).

519.156g The CFTC complaint attacked both margined "long" customer purchases and "short" sales. The court noted that there was no reason to distinguish between long and short transactions because there was no contention for either transaction that Monex did not maintain sufficient physical metal to cover every transaction.

519.157 CFTC v. Monex Credit Co., 931 F.3d 966, 974 (9th Cir. 2019), *cert. denied sub nom.* Monex Deposit Co. v. CFTC, 2020 WL 3492657 (June 29, 2020).

519.158 *Id*. at *5.

519.159 7 U.S.C. §6b.

519.160 The Commission in an earlier settlement order in *In the Matter of Coinflip, Inc., d/b/a Derivabit and Franscisco Riordan*, CFTC Docket No. 15-29 (Sept. 17, 2015) (" *Coinflip*"), found that bitcoins (and by implication, cryptocurrencies generally) are commodities within the provisions of the definition of section 1a(9) of the CEA pertaining to "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." In *Coinflip*, the Commission found that the corporate entity violated sections 4c(b) and 5h(a)(1) of the Act and Commission Regulations 32.2 and 37.3(a)(1) by operating an exchange for the trading of puts and call options on bitcoin without complying with the requirements of trade options and without being registered as a swap execution facility or designated contract market. *Id*. The founder and chief executive officer was found liable as a controlling person under section 13b of the Act. The order imposed a cease-and-desist order against future violations, but did not impose a fine. *Id.*

519.161 The Bitfinex platform also permitted spot transactions in cryptocurrency, but the Commission did not take issue with those.

519.162 *Bitfinex* order at 3.

519.160 Examples of these are bitcoin ("BTC"), Litecoin ("LTC"), Ethereum ("ETH"), Dash, and Ripple ("XRP").

519.161 An example of a security token would be tZERO Security Token.

519.162 Germany, for example, declared bitcoin a "unit of account" in 2013. *See* Charles Arthur, *Bitcoin now 'unit of account' in Germany*, The Guardian (Aug. 19, 2013), available at https://www.theguardian.com/technology/2013/aug/19/bitcoin-unit-of-account-germany. *See generally* James Connington, *Can Bitcoin or any other cryptocurrency actually work as money?*, The Telegraph (Jan. 10, 2018) (discussing the difficulties of cryptocurrency becoming a "unit of account"), available at https://www.telegraph.co.uk/investing/news/can-bitcoin-cryptocurrency-actually-work-money/ ; Robert Cookson, *Bitcoin Analysis Part 2: Can It Ever Become a Unit of Account?*, Medium (Dec. 18, 2017) (arguing that "Bitcoin will never be able to displace the fiat currency of any well-managed economy as the unit of account"), available at https://medium.com/@robert.cookson/bitcoin-analysis-part-2-can-it-ever-become-a-unit-of-account-a266ce6ed4f7.

519.163 An example of an asset-backed token would be Goldmint's GOLD cryptoasset.

519.164 An example of this would be bitcoin futures. *See also* note 519.172 *infra*. In May 2018, the CFTC issued guidance for registered exchanges and clearing houses that wish to list virtual currency derivative products. *See* CFTC Staff Issues Advisory for Virtual Currency Products (May 21, 2018), available at https://www.cftc.gov/PressRoom/PressReleases/7731-18.

519.165 In the Matter of Coinflip, Inc., d/b/a Derivabit, and Francisco Riordan, CFTC Docket No. 15-29 (Sept. 17, 2015).

519.166 In the Matter of BFXNA Inc., d/b/a Bitfitnex, CFTC Docket No. 16-19 (June 2, 2016). *See* fuller discussion in §1.02[12B] and note 519.160 *supra*.

519.167 *See* CFTC Backgrounder on Oversight of and Approach to Virtual Currency Futures Markets (Jan. 4, 2018), available at https://www.cftc.gov/sites/default/files/idc/groups/public/@newsroom/documents/file/backgrounder_virtualcurrency01.pdf ; Lab CFTC, A CFTC Primer on Virtual Currencies (Oct. 17, 2017), available at https://www.cftc.gov/sites/default/files/idc/groups/public/documents/file/labcftc_primercurrencies100417.pdf.

519.168 CFTC v. McDonnell, 287 F. Supp. 3d 213 (E.D.N.Y. Mar. 6, 2018).

519.169 *Id.* at 216–17, 228–29.

519.169a CFTC v. McDonnell, 332 F. Supp. 3d 641 (E.D.N.Y. 2018).

519.169b CFTC v. My Big Coin Pay, Inc., 334 F. Supp. 3d 492 (D. Mass. 2018).

519.169c *Id*. at 498.

519.170 *See, e.g.*, CFTC v. 1pool Ltd. and Patrick Brunner, No. 1:18-cv-02243 (D.D.C. Mar. 4, 2019) (consent order for illegally offering retail commodity transactions that were margined in **b**itcoin, failing to register as a futures commission merchant, and failing to meet its supervisory duties by not having the required anti-money laundering procedures in place) and (Complaint, Sept. 27, 2018); CFTC v. Gelfman Blueprint, Inc. and Nicholas Gelfman, No. 1:17-cv-07181 (S.D.N.Y. Oct. 18, 2018) (consent order in the CFTC's first anti-fraud enforcement action involving bitcoin (as a commodity), finding defendants operated a Bitcoin Ponzi scheme in which they fraudulently solicited more than $600,000 from at least 80 customers; the consent order followed defendant Nicholas Gelman's criminal guilty plea in New York state court to violation of New

York Penal Law 155.25, petit larceny, a class A misdemeanor.); CFTC v. John Doe 1 aka Morgan Hunt d/b/a Diamonds Trading Investment House, No. 4:18-cv-00807 (N.D. Tex. filed Sep. 28, 2018) (charging two defendants with fraudulent solicitation, impersonation of a CFTC investigator, and forging CFTC documents, in an attempt to steal bitcoin); CFTC v. Dillon Michael Dean and The Entrepreneurs Headquarters Limited, No. 2:18-cv-00345 (E.D.N.Y. July 9, 2018) (default judgment finding defendants engaged in a fraudulent scheme to solicit Bitcoin from members of the public, misrepresented that customers' funds would be pooled and invested in products including binary options, and misappropriated pool participants' funds); CFTC v. Blake Harrison Kantor aka Bill Gordon, Nathan Mullins, Blue Bit Banc, Blue Bit Analytics, Ltd., G. Thomas Client Services, and Mercury Cove, Inc., No. 2:18-CV-02247 (E.D.N.Y. filed Apr. 16, 2018) (charging alleged fraud involving binary options on a virtual currency known as ATM Coin).

519.171 CFTC Grants DCO Registration to LedgerX LLC (July 24, 2017), available at https://www.cftc.gov/PressRoom/PressReleases/7592-17.

519.172 *See* CFTC Statement on Self-Certification of Bitcoin Products by CME, CFE and Cantor Exchange (Dec. 1, 2017), available at https://www.cftc.gov/PressRoom/PressReleases/7654-17.

519.173 Retail Commodity Transactions Involving Certain Digital Assets, 85 Fed. Reg. 37734 (June 24, 2020) (Final interpretative guidance). The CFTC issued the proposed interpretative guidance in December 2017. Retail Commodity Transactions Involving Virtual Currency, 82 Fed. Reg. 60335 (Dec. 20, 2017) (Proposed interpretative guidance).

519.174 85 Fed. Reg. at 37741. The CFTC further states that it does not intend for this to be a bright line definition, "given the evolving nature of the commodity and, in some instances, its underlying public distributed ledger technology ('DLT' or 'blockchain')." *Id.*

519.175 *Id.* at 37742–37743. The CFTC states that in applying the "actual delivery" interpretation it will "employ a functional approach and examine how the agreement, contract, or transaction is marketed, managed, and performed, instead of relying solely on language used by the parties in the agreement, contract, or transaction," and will assess all relevant factors. *Id.*

519.176 *Id*. at 37739. The final interpretation contains five non-exclusive examples to clarify the CFTC's of actual delivery in the context of virtual currencies. *Id*.

519.177 Jay Clayton & J. Christopher Giancarlo, *Regulators Are Looking at Cryptocurrency*, Wall St. J . (Jan. 24, 2018), available at https://www.wsj.com/articles/regulators-are-looking-at-cryptocurrency-1516836363. *See also Virtual Currencies: The Oversight Role of the U.S. Securities and Exchange Commission and the U.S. Commodity Futures Trading Commission: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* (Feb. 6, 2018) (both Chairman Giancarlo and Chairman Clayton testifying), available at https://www.banking.senate.gov/hearings/virtual-currencies-the-oversight-role-of-the-us-securities-and-exchange-commission-and-the-us-commodity-futures-trading-commission. The SEC and CFTC also recently approved a non-binding Memorandum of Understanding to increase their coordination and cooperation in areas of common regulatory interest, including "to facilitate the introduction of novel derivative products or other products to market users and investors." CFTC and SEC Announce Approval of New MOU (June 28, 2018), available at https://www.cftc.gov/PressRoom/PressReleases/7745-18.

519.178 In a July 25, 2017, report issued pursuant to Section 21(a) of the Securities Exchange Act, the SEC opined that virtual tokens offered and sold by a "virtual" organization known as the "Decentralized Autonomous Organization" or "the DAO" were securities subject to federal securities laws because, applying the Supreme Court's interpretation of the definition of "security" in SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (*i.e.*, "the *Howey* Test"), the tokens were investment contracts because they were offered for the purpose of raising capital to fund "projects" from which token holders could profit. *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: The DAO (July 25, 2017), available at https://www.sec.gov/litigation/investreport/34-81207.pdf. The SEC's report also recognized that not all virtual currencies or tokens are securities; rather, it depends on the facts and circumstances of each transaction.

In December 2017, the SEC's consensual cease-and-desist order in *In re Munchee Inc.* concluded, applying the *Howey* Test, that the company's initial offering of a virtual token for the purpose of raising capital to improve the company's online "ecosystem" for the sale of its products and services would constitute the sale of unregistered securities. In the Matter of Munchee Inc., SEC Docket No. 3-18304 (Dec. 11, 2017), available at https://www.sec.gov/litigation/admin/2017/33-10445.pdf. The tokens were designed to be the medium of exchange for purchasing the company's goods and services. The order concluded that the tokens functioned as investment contracts because the offering documents envisioned that the tokens could increase in value as a result of improvements to the company's ecosystem.

On June 14, 2018, in remarks at the Yahoo All Markets Summit, the Director of the SEC Division of Corporate Finance ventured a personal view that bitcoin and the current offers and sales of Ether are not securities transactions, and outlined a nonexclusive list of facts and circumstances that bear on whether a digital asset is a security. *See* William Hinman, *Digital Asset Transactions: When Howey Met Gary (Plastic)*, Address Before the Yahoo Finance All Markets Summit: Crypto (June 14, 2018), available at https://www.sec.gov/news/speech/speech-hinman-061418.

519.179 *See* Order Disapproving a Proposed Rule Change, as Modified by Amendments No. 1 and 2, to BZX Rule 14.11(e)(4), Commodity-Based Trust Shares, to List and Trade Shares Issued by the Winklevoss Bitcoin Trust, SEC Release No. 34-80206 (Mar. 10, 2017), available at https://www.sec.gov/rules/sro/batsbzx/2017/34-80206.pdf. In March 2018, the SEC also began the process of reviewing two other bitcoin ETFs to be listed on the NYSE Arca exchange. *See* Order Instituting Proceedings to Determine Whether to Approve or Disapprove a Proposed Rule Change to List and Trade the Shares of the ProShares Bitcoin ETF and the ProShares Short Bitcoin ETF under NYSE Arca Rule 8.200-E, Commentary.02, SEC Release No. 34-82939, available at https://www.sec.gov/rules/sro/nysearca/2018/34-82939.pdf. The two ETFs—Proshares Bitcoin ETFs and Proshares Short Bitcoin ETFs—track bitcoin futures contracts on the CBOE and the CME.

519.180 *See, e.g.*, SEC v. Longfin Corp., No. 18-CV-2977 (S.D.N.Y. filed Apr. 4, 2018) (alleged illegal distributions and sales of restricted shares); SEC v. Centra Tech., Inc., No. 18-CV-02909 (S.D.N.Y. filed Apr. 2, 2018) (alleged fraudulent initial coin offering); SEC v. Jon E. Montroll, No. 18-CV-01582 (S.D.N.Y. filed Feb. 21, 2018) (alleged fraud and operating unregistered securities exchange); SEC v. Arisebank, No. 18-CV-00186 (N.D. Tex. filed Jan. 25, 2018) (allegedly fraudulent initial coin offering).

519.181 SEC Strategic Hub for Innovation and Financial Technology ("FinHub"), *Framework for "Investment Contract" Analysis of Digital Assets* (Apr. 3, 2019), available at https://www.sec.gov/corpfin/framework-investment-contract-analysis-digital-assets. The Framework explains that it represents the views of the Strategic Hub for Innovation and Financial Technology of the SEC. It is not a rule, regulation, or statement of the SEC, and SEC has neither approved nor disapproved its content. Further, this framework does not replace or supersede existing case law, legal requirements, or statements or guidance from the SEC or Staff. Rather, the framework provides additional guidance in the areas that the SEC or Staff has previously addressed." *Id.* at note 1.

519.182 TurnKey Jet, Inc. (SEC No-Action Letter, Apr. 3, 2019), available at https://www.sec.gov/divisions/corpfin/cf-noaction/2019/turnkey-jet-040219-2a1.htm.

519.183 *See* note 519.178, *supra*.

519.184 *Id.*

519.185 The Framework characterizes this element as "reliance on the efforts of others" in contrast to prior staff formulations which use the phrase "derived from the managerial efforts of others." The new formulation arguably is broader, requiring just a showing of reliance rather than that something was "derived" from the efforts of others.

519.186 Custody issues can bear on the regulatory status of digital assets, too. The TurnKey Jet letter requesting no-action relief described an escrow regime for the U.S. dollars underlying the tokens as bank deposits on a one-to-one ratio, with escrow balances being subject to independent audit.

519.187 The White Paper, which is available at https://www.americanbar.org/content/dam/aba/administrative/business_law/buslaw/committees/CL620000pub/digital_assets.pdf, was prepared by the Jurisdiction

Working Group of the American Bar Association's Derivatives and Futures Law Committee's Innovative Digital Products and Processes Subcommittee.

520 Sections §§2(c)(1), 2(d), 7 U.S.C. §§2(c)(1), 2(d), CCH Rep. ¶¶ 1023, 1024.

521 Section 2(h), 7 U.S.C. §2(h), CCH Rep. ¶ 1028.

522 Section 2(g), 7 U.S.C. §2(g), CCH Rep. ¶ 1029.

523 For detailed discussion of margin rules under the securities laws, *see* Jerry W. Markham & Thomas Lee Hazen, Broker-Dealer Operations and Regulation Under Securities and Commodities Laws ch. 8 (2d ed. 2003).

524 *See* §7 of the Securities Exchange Act, 15 U.S.C. §78g, and Regulation T of the Board of Governors of the Federal Reserve System, 12 C.F.R. Pt. 220 ; 3 Thomas Lee Hazen, Treatise on the Law of Securities Regulation §14.9 (Practitioner's Ed. 4th ed. 2002).

524.1 *See infra* § 1.05[3] for a discussion of new rules providing clearing organizations with margin-setting responsibilities.

525 7 U.S.C. §6d(2), CCH Rep. ¶ 1071. For additional discussion of commodity margins (as well as credit regulation under the federal securities laws), *see* 23 Jerry W. Markham & Thomas Lee Hazen, Broker-Dealer Operations Under Securities and Commodities Law—Financial Responsibilities, Credit Regulation and Customer Protection Ch 8 (2d ed. 2003).

526 *See* Smith, The Custom of Margin Calls and Closing Out Commodity Futures Accounts Lacking Sufficient Margin—The Rule of Unwritten Law, 13 Sec. Reg. L.J. 99 (1985).

527 Interpretative Letter No. 96-12, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,623 (CFTC Div. of Trading & Markets, Jan. 31, 1996) (Reg. §33.4(a)(2), 17 C.F.R. §33.4(a)(2), CCH Rep. ¶ 2744 requires payment be made at the time of the transaction). Prompt payment is required even if the FCM fails to make a demand. CFTC Interpretative Ltr. No. 96-49, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,725 (CFTC Div. of Trading & Markets, June 4, 1996) (it is the FCM's responsibility to demand payment but the customer's liability is not dependent on the demand).

528 Although an uncommon practice, some FCMs in the past had offered programs to individual customers whereby the FCMs guarantee or agree to limit the losses occasioned by those customers' trading. The Commission found this practice to be unsafe and prohibited FCMs from making such agreements with their customers. *See* Rule 1.56. *See also* §3.08[8] *infra*.

529 Section 8a(7)(c), 7 U.S.C. §12a(7)(c), CCH Rep. ¶ 1307. The Commission, however, has issued orders directing a contract market to set a particular level of margin by invoking its emergency authority under §8a(9) (7 U.S.C. §12a(9)), CCH Rep. ¶ 1309. *See, e.g.*, the Commission's order to the New York Mercantile Exchange, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,233 (Nov. 3, 1976), and a subsequent explanation by the Commission's chairman, [1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,237.

The SEC and CFTC adopted joint rules on the margin requirements for security futures products. *See* Customer Margin Rules Relating to Security Futures, 67 Fed. Reg. 53146-01, 2002 WL 1840540 (CFTC, SEC Aug. 14, 2002).

[530] [Reserved.]

531 Once the customer's deposit falls below the maintenance level, it is necessary on some exchanges that the customer restore his account to the initial margin level. *See, e.g.*, Chicago Board of Trade Rule 431.02(14). A more extensive discussion of margins is found *infra* §2.06[2]. It is permissible for a broker to charge interest on a customer's unpaid margin balance. *See, e.g.*, Purdy v. CFTC, 968 F.2d 510 (5th Cit. 1992).

There is no regulation of margin transactions when the underlying contract relates to a cash, forward, or spot transaction, and therefore, is not a futures contract. *See, e.g.*, Krommenhoek v. A-Mark Precious Metals, Inc., [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,952 (D. Idaho 1990), *aff'd and vacated in part on* *other grounds*, 945 F.2d 309 (9th Cit. 1991) (delayed delivery on margin purchases of precious metals did not result in a futures contract since purchasers believed that delivery would be forthcoming).

532 A more extensive discussion of hedging can be found *infra* §1.03[2].

533 A more extensive discussion of spreading can be found *infra* §1.03[5].

534 *See infra* §2.06[9].

535 Futures trading is popularly referred to as a zero-sum game. Since every long position comes into being only if there is a countervailing short position (and vice versa) and since one position's gain is necessarily the other position's loss, the gains and losses at any given time net out to zero. By contrast, in the securities market, a fortunate investor with appreciating stock is not inflicting a loss on any other stockholder.

536 The Commission's regulations requiring the segregation of customer funds recognize and do not prohibit a carrying broker from investing customer funds in qualified investments. *See* Reg. §1.29, 17 C.F.R. §1.29, CCH Rep. ¶ 2156. Under that Regulation, the carrying broker is not prevented from "receiving and retaining as its own any increment or interest resulting" from those investments. *See also, e.g.*, Marchese v. Shearson Hayden Stone, Inc., 822 F.2d 876 (9th Cit. 1987) (upholding right of futures commission merchant to retain interest on customers' margin deposits).

537 *See, e.g.*, Allen v. ADM Investor Services, Inc., [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,365 (CFTC Initial Dec. 1995) (rejecting claim that broker negligently timed the margin call). *See also, e.g.*, Geldermann v. Financial Management Consultants, 27 F.3d 307 (7th Cir. 1994) (in a state law claim there was a failure to establish that alleged unreasonable delay in liquidation caused damage to the investor).

537.1 A customer's failure to satisfy the margin call can render the customer liable to the broker for the broker's resulting losses. *See* ADM Investor Servs, Inc. v. Collins, 515 F.3d 753 (7th Cir. 2008) (trader held liable to FCM for trader's failure to respond to margin call; claimed illegality of transaction did not excuse trader's obligations to comply with the margin call); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Brooks, 548 F.2d 615 (5th Cir. 1977) (broker could recover from customer even though commodities account was under-margined). *See also, e.g.,* Thomson McKinnon Securities, Inc. v. Clark, 901 F.2d 1568 (11th Cir. 1990) (securities broker's extending too much credit in violation of the margin rules was not a defense to the broker's suit against customer).

538 *See, e.g.*, Faro v. Interlink Trading, Inc., [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,537 (CFTC 1995) (ALJ's order of dismissal was reversed since the customer establishes a prima facie violation by demonstrating that the FCM liquidated one or more positions without seeking specific authorization); *infra* §5.09[8].

539 There are only narrow circumstances in which a broker will be relieved of the obligation to inform the customer of a margin call. Slone v. Dean Witter Reynolds, Inc., [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,283 (CFTC Initial Dec. 1994). *See also, e.g.*, First Am. Discount Corp. v. Jacobs, 324 Ill. App. 3d, 258 Ill. Dec. 291, 756 N.E.2d 273, 279 (2001) (brokerage firm may liquidate under-margined account without prior margin call when customer is inaccessible); Slone v. Dean Witter Reynolds, Inc., [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,564 (CFTC Initial Dec. 1995) (account was lawfully liquidated because of margin call).

540 The Commission's order to the New York Mercantile Exchange of Nov. 3, 1976 ([1975-1977 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,233 (Nov. 3, 1976)) directed an increase in margins on the November 1976 Maine potato futures contract to 100 percent of the contract's value and, in addition, foreclosed the acquisition of new positions. The latter action would have been sufficient to restrict access to the worrisome market. The 100 percent margin requirement, applying to all open positions, would seem to create a condition for near-panic liquidation by market participants unable to raise such substantial sums immediately.

541 *See* CME Wins CFTC Approval of New Option-Margining System, 20 Sec. Reg. & L. Rep. (BNA) 1837 (Dec. 2, 1988).

542 *See* Chicago Exchanges Ask CFTC to Allow Futures-Style Margining of Options, 21 Sec. Reg. L. Rep. (BNA) 472 (Mar. 24, 1989).

543 17 C.F.R. §33.4(a)(2), CCH Rep. ¶ 2744. *See* Final Rulemaking Permitting Futures-Style Margining of Commodity Options, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,320 (CFTC June 16, 1998).

544 *See infra* §2.06[2].

545 *See* Chicago Exchanges Ask CFTC to Allow Futures-Style Margining of Options, 21 Sec. Reg. L. Rep. (BNA) 472 (Mar. 24, 1989).

546 *See* CME and OCC Announce Cross-Margining Agreement, 20 Sec. Reg. & L. Rep. (BNA) 1487 (Sept. 30, 1988).

547 There has been some movement in this direction. *See* CFTC Seeks Comments on CME-OCC Cross-Margining Proposal, 21 Sec. Reg. & L. Rep. (BNA) 699 (May 12, 1989). *See also, e.g.*, Miller, Regulators Foresee Clearing Reforms Cross-Margining Proposals Advance, 8 Commod. L. Ltr. 1 (Nov.-Dec. 1988).

548 *See* 21 Sec. Reg. & L. Rep. (BNA) 1479 (Sept. 29, 1989). The scope of the cross-margining programs continues to be expanded. *See, e.g.*, Memorandum Recommending Approval of Proposals to Expand Cross-Margining Programs, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,190 (CFTC Div. of Trading & Markets, Nov. 26, 1992); Approval of Chicago Mercantile Exchange Proposal, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,191 (Dec. 3, 1991); CFTC, SEC Approve Expansion of CME, OCC Cross-Margining Systems, 23 Sec. Reg. & L. Rep. (BNA) 1715 (CFTC Nov. 26, 1991).

549 Id.; Horwitz & Cawley, Cross-Margining: A Clearing Perspective, 10 Commod. L. Letter 1 (Nos. 9 & 10, November/December 1990). In what may be a precedent-setting decision, the Indiana Court of Appeals has ruled that directors and managers of an organization (here a farm cooperative) breached the standard of care required under state law by failing to become better acquainted with hedging techniques that might have avoided a large loss on grain sales, and held those officials personally liable for the losses. Brane v. Roth, 590 N.E.2d 587 (Ind. 1992).

The bankruptcy rules were amended in order to assure that customers who are not involved in cross-margined transactions do not bear the risk of a shortfall in the firm's cross-margined funds. This was accomplished through the addition of a new appendix to the rules. *See* [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,029 (CFTC 1994).

550 *See* Fed Delegates Authority to CFTC to Set Margins on Stock Index Futures, 25 Sec. Reg. & L. Rep. (BNA) 563 (Apr. 16, 1993).

551 *See supra* §1.02[9][D].

552 Bibbo v. Dean Witter Reynolds, Inc., 151 F.3d 559 (6th Cir. 1998) (state law that would have precluded futures commission merchants from retaining interest on commodity margin was preempted by federal law).

553 Section 4s(e), 7 U.S.C. 4s(e); Securities Exchange Act Section 15F(e), 15 U.S.C. **§§** 78a *et seq*.

554 *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27563–27596 (May 11, 2011); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23732–23749 (Apr. 28, 2011); Capital, Margin and Segregation Requirements for Security-Based Swap Dealers and Major Security-Based Swap Participants and Capital Requirements for Broker-Dealers, 77 Fed. Reg. 70213–70354 (Nov. 23, 2012).

555 *See* Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (Sept. 24, 2014); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898–59936 (Oct. 3, 2014).

555.1 *See* Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015); Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

556 *See* Margin Requirements for Non-Centrally Cleared Derivatives, available at http://www.bis.org/publ/bcbs261.pdf (Sept. 2013).

557 Terrorism Risk Insurance Program Reauthorization Act of 2015, H.R. 26 (114th Cong. 1st sess. 2015).

557.1 Letter from Michael A. Macchiaroli, Associate Director, SEC Division of Trading and Markets to Kris Dailey, Vice President, Risk Oversight and Operational Regulation, Financial Industry Regulatory Authority Regarding Treatment under Rule 15c3-I of Margin Posted by Broker-Dealers with Respect to Swaps (Aug. 19, 2016).

557.2 Generally, swaps executed prior to applicable compliance dates of the uncleared swap margin rules ("Legacy Swaps") are not subject to uncleared swap margin requirements. However, amendments to Legacy Swaps following the compliance date would cause such swaps to require compliance with the margin requirements. In June 2019, the CFTC granted no-action relief permitting various types of amendments, such as partial terminations, immaterial amendments and swaption exercises, to Legacy Swaps not to be treated as creating new swaps subject to the uncleared swap margin requirements. CFTC Letter No. 19-13, June 6, 2019. The CFTC has also adopted an interim final rule amending its margin requirements for uncleared swaps for swap dealers and major swap participants for which there is no prudential regulator such that Legacy Swaps may retain their legacy status under CFTC margin rules if transferred in accordance with specified conditions due to a withdrawal by the United Kingdom from the European Union in a "No-deal Brexit," *i.e.*, without a negotiated agreement permitting United Kingdom firms to continue to provide investment services in the European Union pursuant to the current "passporting" regime. Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 84 Fed. Reg. 12065 (Apr. 1, 2019).

557.3 Department of the Treasury Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency, Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39754 (July 1, 2020) (Final rule), and CFTC, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 19878 (Apr. 9, 2020).

557.4 Department of the Treasury Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency, Margin and Capital Requirements for Covered Swap Entities, 85 Fed. Reg. 39464 (July 1, 2020) (Interim final rule and request for comment); CFTC, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 41346 (July 10, 2020) (Interim final rule with request for comment).

557.5 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 41463 (July 10, 2020) (Notice of proposed rulemaking). On August 14, 2020, the Commission approved issuing for comment two proposals to amend its uncleared margin requirements for swap dealers and major swap participants to (i) align the calculation of initial margin with BCBS/IOSC standards and (ii) revise how minimum transfer amount requirements apply. The voting drafts of the proposals are available at cftc.gov/PressRoom/PressReleases/8219-20.

558 Protection of Collateral of Counterparties to Uncleared Swaps; Treatment of Securities in a Portfolio Margining Account in a Commodity Broker Bankruptcy, 78 Fed. Reg. 66621 (CFTC Nov. 6, 2013).

559 *See* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59898–59936 (CFTC Oct. 3, 2014).

560 *Id.* The new rules also clarify, pursuant to section 20(c) of the Act that securities in a portfolio margining account that is a futures account or a Cleared Swaps Customer Account will constitute "customer property" and owners of such accounts are "customers" in a commodity broker bankruptcy.

561 Staff Interpretation Regarding the Notification of Right to Segregation of Initial Margin in Uncleared Swap Transactions and Quarterly Reporting under Commodity Futures Trading Commission Regulations 23.701 and 23.704, (CFTC No-Action Letter No. 14-132, Oct. 31, 2014).

562 *Id*.

563 *Id*.

563.1 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants—Cross-Border Application of the Margin Requirements, 81 FR 34818 (May 31, 2016).

563.2 Time Limited No-Action Position for Swap Dealers Complying with European Union Uncleared Swap Margin Requirements (CFTC No-Action Letter No. 17-05, Feb. 1, 2017).

563.3 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 41463 (July 10, 2020) (Notice of proposed rulemaking).

563.4 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 85 Fed. Reg. 27674 (May 11, 2020) (Final rule).

563.5 Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 84 Fed. Reg. 56392 (Oct. 22, 2019) (Proposed rule). The CFTC granted the no-action relief it codified in the rule change in CFTC Letter No. 17-34, No-Action Position with Respect to Uncleared Swaps with the European Stability Mechanism (July 24, 2017).

564 Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69334 (CFTC Nov. 8, 2011). In 2013, the District Court for the District of Columbia dismissed a challenge to the CFTC's margin rules for cleared swaps, holding that the petitioner, the prospective sponsor of a swap execution facility, lacked standing to challenge those rules. Bloomberg LP v. U.S. CFTC, No. 13-523, 2013 WL 2458283 (D.D.C. June 7, 2013).

565 17 C.F.R. § 39.13(g)(8)(ii).

566 Derivatives Clearing Organization General Provisions and Core Principles, 76 Fed. Reg. 69,334 (CFTC Nov. 8, 2011).

567 Protection of Cleared Swaps Customer Contracts and Collateral and Conforming Amendments to the Commodity Broker Bankruptcy Provisions, 77 Fed. Reg. 6336 (CFTC Feb. 7, 2012).

568 *Id*.

569 *Id*.